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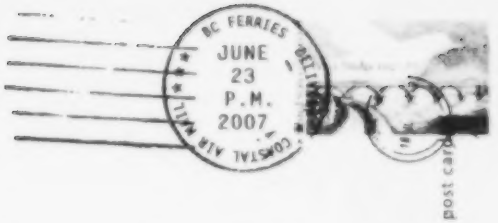
Sunshine Coast, British Columbia



Hi Mom,

Having a great time ferry-hopping around B.C. We just finished a big breakfast of strawberry-topped waffles at the Pacific Buffet and now we're lounging on the deck enjoying some amazing scenery through the island channels. What an experience! Gonna check out the gift shop and grab a bestseller for the rest of our trip. You'd love this!

See you soon.

Love, Sonny

AIR MAIL

BRITISH COLUMBIA FERRY SERVICES INC.

Corporate Profile 03
A Message from the Chair 05
A Message from the President & CEO 09
Operating Highlights & Performance Measures 13
Our Goals 15
- Safety 15
- Operational Reliability 17
- Continuous Improvement 21
- Value for Money 24
- Financial Integrity 28
BC Ferries' Fleet 30
BC Ferries' Routes 31
Management's Discussion & Analysis of Financial Condition & Results of Operations 33
Consolidated Financial Statements 64
Corporate Directory 79

B.C. FERRY AUTHORITY

A Message from the Chair 81
2006/07 Annual Report 82
Summary of Meetings 83
Statement of Financial Position 86
Corporate Directory Inside Back Cover

This report contains historical information and may contain certain forward-looking statements that relate to future events or future performance. These forward-looking statements are based upon management's current expectations and assumptions as to a number of factors, including the risks, uncertainties and other factors as described in BC Ferries' Management's Discussion and Analysis contained herein and certain of the other BC Ferries documents available at www.sedar.com. These forward-looking statements are made as of today's date and are based upon information currently available to management, and BC Ferries assumes no obligation to update or revise them to reflect new events or circumstances. If management's expectations and assumptions prove to be incorrect or factors change, then actual results could differ materially from the forward-looking information contained in this report.

2 Sailing from Departure Bay, Vancouver Island

Who We Are

BC Ferries is one of the largest ferry operators in the world, providing year-round vehicle and passenger service on 25 routes to 47 terminals, with a fleet of 36 vessels. We are an essential transportation link that connects coastal communities and facilitates the movement of people, goods and services throughout British Columbia. Our 3,900 employees provide the best in safety and service every day as we transport more than 21 million passengers and 8.5 million vehicles each year.

Our Vision

To provide a continuously improving west coast travel experience that consistently exceeds customer expectations and reflects the innovation and pride of our employees.

Our Mission

To provide safe, reliable and efficient marine transportation services which consistently exceed the expectations of our customers, employees and communities, while creating enterprise value.

Definition of Success

At BC Ferries, our definition of success is to provide to our customers integrated marine transportation services that are safe, reliable and continuously improving, while delivering best value for money and operating in a manner that preserves our financial integrity.

Our Values

Safety

Ensure that the safety and security of our customers and staff is a primary concern in all aspects of doing business.

Quality

Be motivated by customer expectations in providing quality facilities and services.

Integrity

Be accountable for all our actions and ensure we demonstrate integrity in our business relations, utilization of resources, treatment of our customers and staff, and in the general conduct of our business.

Partnerships

Work openly and constructively with our various business and community stakeholders to exceed the expectations of our customers and advance each other's interests.

Environment

Ensure that environmental standards are maintained.

Employees

Always deal from a position of honesty, integrity and mutual respect, and ensure that our employees develop to their full potential.

Our Goals

In support of our vision, we are focused on five key goals, none more important than safety.

1. **Safety**
   To continuously improve the safety of our operations inclusive of vessels, terminals and facilities.
2. **Operational Reliability**
   To continuously improve the operational reliability of vessels, terminals and facilities.
3. **Continuous Improvement**
   To be better at everything we do.
4. **Value For Money**
   To continuously improve value to our customers at every point along the customer experience chain.
5. **Financial Integrity**
   To achieve key financial targets, ensuring that sufficient capital and retained earnings are available to revitalize our fleet, facilities and infrastructure, while minimizing fare escalation.

4 Elizabeth J. Harrison, QC, Chair, Board of Directors

"In our next year of operations, we will continue to make safety our top priority as we introduce new vessels, upgrade our infrastructure and build exciting new travel experiences that all of our customers can enjoy."

Over the year, our focus remained on the safety of our operations and the continued improvement of service to our customers.

We invested all of our profits to purchase new ships and upgrade our infrastructure, and made significant enhancements in all areas of our business. We also worked diligently to overcome a number of business challenges, including the restoration of service to the north coast and the continued high cost of fuel.

As part of our ongoing commitment to provide the best and safest ferry service, we commissioned former BC Auditor General George L. Morfitt to conduct a comprehensive review of operational safety at BC Ferries. In January, we welcomed Mr. Morfitt's report, which concluded that overall BC Ferries operates a safe coastal ferry transportation system and that we are highly committed to operational safety, both for the travelling public and for our employees. We are currently implementing the 41 safety enhancement recommendations in Mr. Morfitt's report.

Extensive work was done by BC Ferries over the year in relation to the second Performance Term of the Coastal Ferry Services Contract, which will begin in April 2008.

On behalf of the Board of Directors, we thank our dedicated and skilled employees for their hard work and their continued commitment to ensuring that we provide the best and safest service to our customers each and every day.

In our next year of operations, we will continue to make safety our top priority as we introduce new vessels, upgrade our infrastructure and build exciting new travel experiences that all of our customers can enjoy.

Elizabeth J. Harrison, QC
Chair

In memory of Ray Whitehead and his dedication in serving as a member of the Board of Directors of BC Ferries.

Ray Whitehead
January 15, 1941 - June 11, 2007

Ray Whitehead passed away on June 11, 2007 after a courageous battle with lung cancer.

Ray was a long-time member of BC Ferries' Board of Directors, serving as the nominee of the BC Ferry & Marine Workers' Union from June 24, 1998 to June 11, 2007. In addition to being an active and enthusiastic member on a variety of Board committees, Ray served on the Boards of BC Ferries' subsidiary, Catamaran Ferries International Inc., and B.C. Ferry Authority.

During his thirty-year career, Ray also held the positions of Regional Director of the Canadian Union of Public Employees in B.C., Treasurer of Branch 263 of the Royal Canadian Legion and Director on the Board of the British Columbia Safety Authority.

We are grateful for Ray's extensive service and contribution to BC Ferries. He proudly represented the interests of ferry workers, the company and the travelling public with balance, integrity and humour, and was a consistent presence on the vessels and at the terminals where he took a personal interest in the working lives of our employees. His input and involvement have been instrumental to the growth and development of BC Ferries.

Ray is deeply missed and fondly remembered for his kindness, dedication and commitment to his family, friends and colleagues.

8 David L. Hahn, President & Chief Executive Officer

"This past year was an exciting time for BC Ferries as we made tremendous advances in all areas of our business... Clearly, a new era at BC Ferries is underway."

This past year was an exciting time for BC Ferries as we made tremendous advances in all areas of our business. From extensive terminal improvements to enhanced customer amenities to the start of the most significant vessel replacement program in our company's 47-year history, we continued to pursue our vision of providing a continuously improving west coast travel experience. Clearly, a new era at BC Ferries is underway.

In a year that saw more than 21.6 million passengers travel with us, I am proud of the exceptional service our employees delivered while providing a memorable experience for all of our customers. From the first point of contact with our reservation agents to the experience at our terminals and onboard our vessels, our employees were there to provide safe, reliable and exceptional service each and every day.

I am also proud of the dedicated effort by the many employees who worked diligently to find a replacement vessel to restore full service on our northern routes. In September, after a worldwide search, we purchased a 600-passenger vessel that would be renamed the *Northern Adventure*. The vessel entered service on the north coast on March 31, 2007 after undergoing more than $30 million in modifications. We appreciate the patience and support of our customers, stakeholders, local communities and tourism operators as we worked to restore full service to the north.

In June 2006, as part of our ongoing commitment to ensure the safety of our passengers and crew, we commissioned George L. Morfitt, former BC Auditor General, to conduct an independent review of our safety policies, procedures and practices. In January, Mr. Morfitt released his findings and concluded that BC Ferries operates a safe coastal ferry transportation system; however, there are areas where safety and related administrative processes and procedures could be strengthened.

A Message From The President & CEO continued

In his report, Mr. Morfitt made 41 recommendations for safety enhancements. We are committed to working with the BC Ferry & Marine Workers' Union as we implement all of the recommendations.

In keeping with our focus on safety, this past year we launched a comprehensive, company-wide safety program to ensure that all of us at BC Ferries continue to put safety first each and every day. In addition, we added a new goal to our annual business plan and our long-term strategic plan to ensure we are continuously improving the safety of our operations.

Looking back on the year, we started to see the results of our significant investments in infrastructure. For the first time in 11 years, we added new vessels to our fleet—the *Kuper*, operating on the Chemainus-Thetis-Kuper route, and the *Northern Adventure*, operating on our northern Port Hardy-Prince Rupert-Queen Charlotte Islands routes.

A major milestone for BC Ferries was the beginning of construction on the *Coastal Renaissance* and *Coastal Inspiration*, our first two new Super C-class vessels, and on our new $57 million, 125-car ferry.

In mid-April 2007, the *Coastal Renaissance* was officially launched and construction began on the *Coastal Celebration*, the third Super C. By the end of 2007, the *Coastal Renaissance* will arrive in B.C. waters, followed by the *Coastal Inspiration* and *Coastal Celebration* in early and mid 2008, respectively. These three new Super Cs will provide a world-class travel experience for the next 40 years to passengers travelling between the Lower Mainland and Vancouver Island.

The addition of new vessels, combined with significant investments in our current fleet, including $38 million upgrades to both the *Queen of Surrey* and *Queen of Alberni* this past year, enable us to continue to provide safe, reliable and efficient service, while raising the bar on the overall customer experience.

A visit to our terminals reveals the significant investments we made this past year. In October, we opened a new $24 million state-of-the-art floating berth at Swartz Bay, one of our busiest terminals, and began a $63 million upgrade at Departure Bay and Horseshoe Bay terminals to replace aging infrastructure, increase customer amenities and prepare for the arrival of the Super Cs. Our considerable terminal investments extended throughout the company with new marine structures at Alliford Bay, Buckley Bay, Chemainus, Gabriola, Kuper Island, Little River, Long Harbour and Saltery Bay. We also began dock modifications at Port Hardy, Prince Rupert, Skidegate, Klemtu and McLoughlin Bay to accommodate our new northern fleet.

Consistent with our commitment to improve the complete customer experience, this past year we added new electronic highway signs on the Island Highway, vessel tracking maps and arrival times on our website, automated ticketing machines at Swartz Bay and Tsawwassen terminals, late-night sailings in support of special events and innovative pricing promotions for our customers. We are pleased to report that our efforts to improve customer service are continuing to show positive results, with an overall customer satisfaction rating of 89 per cent last year, up from 86 per cent the previous year.

To ensure that we are listening to our customers and stakeholders and providing important information about BC Ferries, we met regularly with our Ferry Advisory and Terminal Liaison Committees on matters of mutual interest, including core service levels related to the Second Performance Term of the Coastal Ferry Services Contract that begins in April 2008.

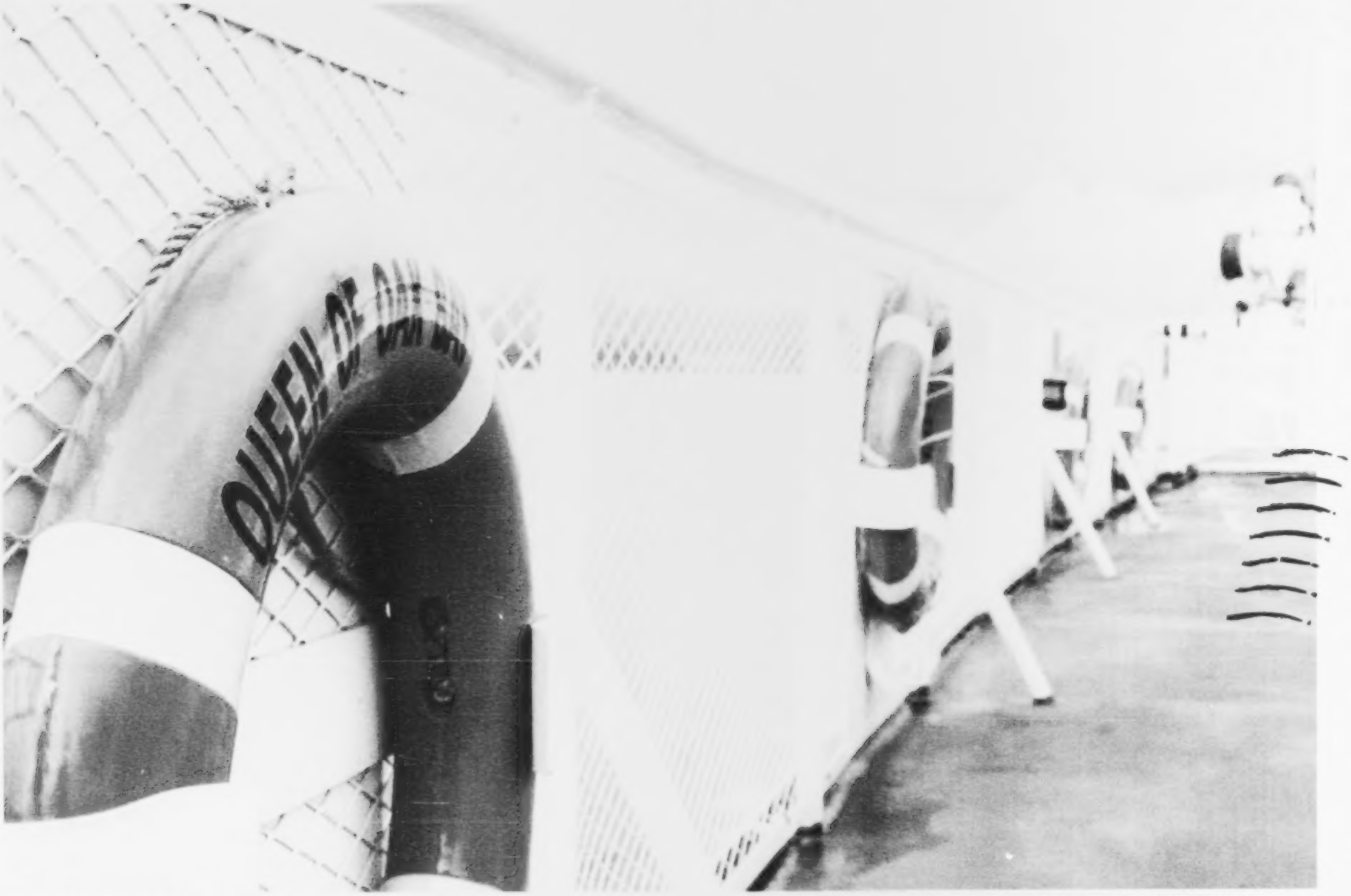
Last September, we made a comprehensive submission to the BC Ferries Commissioner in consideration of price cap for the second performance term. On March 31, 2007, the Commissioner provided his preliminary price caps to BC Ferries and the Province of British Columbia, and released the information to the public. The Commissioner will consider any amendments to the Coastal Ferry Services Contract approved by the provincial government by June 30, 2007 before releasing a final ruling on price caps by September 30, 2007. We will continue to keep our customers and stakeholders informed about this important process.

While we met our business goals this past year, the high cost of fuel was a major and ongoing challenge, even with the addition of a third fuel surcharge authorized by the Commissioner in June 2006. While we achieved considerable reductions in fuel consumption, the balance in our deferral account was still $18.8 million by the end of the year. We are continuing to look for ways to further reduce our fuel consumption and lower our fuel deferral account balance.

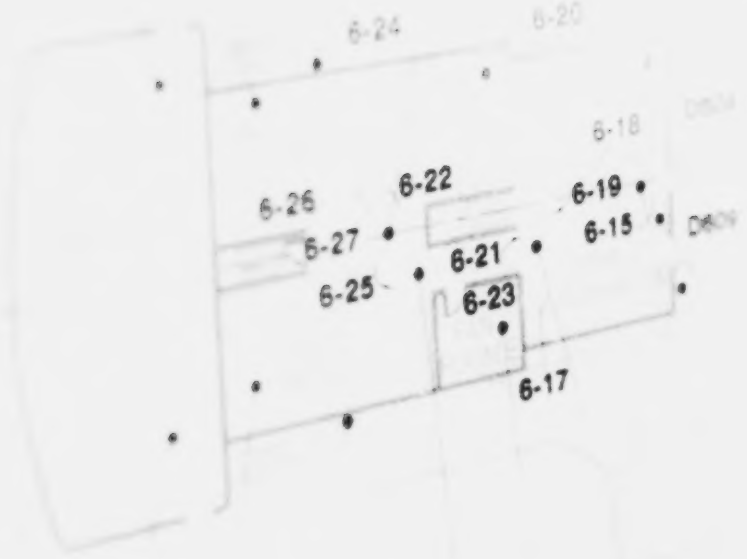
As I look back on the year, I take pride in our many accomplishments as we worked to create an even better BC Ferries. The future holds tremendous opportunities to expand our business and provide a world-class experience to our customers through our skilled employees, state-of-the art new ships, upgraded terminals and enhanced products and services.

We hope you will join us onboard and be part of the BC Ferries experience.

David L. Hahn
President & Chief Executive Officer



Sailing the Strait of Georgia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Operational Highlights & Performance Measures

Measuring Our Success

The Board of Directors and management of BC Ferries have implemented comprehensive long-term performance measures to gauge the progress of the business and our commitment to continuous improvement.

Performance Measures	2004/05	2005/06	2006/07
Employee Safety (employee injury frequency rate times the severity rate divided by 1000)	2.71	2.02	3.08
Passenger Safety (number of passenger injuries per one million passengers)	13.67	13.58	11.31
Reliability (round trips divided by scheduled round trips)	99.69%	99.48%	99.66%
On-time performance (departures within ten minutes of departure time)	84.3%	85.3%	86.3%
Asset reinvestment (weighted average age of vessels by gross registered tonnes)	28.9 years	29.5 years	25.4 years
Customer Satisfaction Rating	88%	86%	89%
Cost per passenger	$ 17.56	$ 16.45	$ 17.07
Earnings per full-time equivalent (FTE) employee ($ thousands) (FTEs are calculated by dividing the actual hours worked by 1,827, the standard hours in a work year)	$ 32.53	$ 36.94	$ 37.54
Earnings before interest, taxes, amortization and extraordinary gain ($ millions)	$ 112.0	$ 128.1	$ 123.6 [1]
Net earnings ($ millions)	$ 39.8	$ 49.9	$ 48.8 [2]

[1] 2006/07 reflects the impact of the increased wages and benefits for lump-sum payments to employees totalling $3.6 million as a result of a mediation-arbitration award and a $5.0 million reduction from anticipated performance due to the loss of the *Queen of the North* and the modified service delivery on our northern routes.

[2] Net earnings do not include an extraordinary gain of $61.3 million for the year ended March 31, 2007. See Management's Discussion & Analysis for further information.

14 A routine safety inspection check

We were chatting with the Captain and she told us that the crew on every vessel has hands-on fire and boat drills every two weeks – more than 1,000 safety drills a year!

A Clear Commitment

At BC Ferries, we put the safety of our customers and crew first. This past year was no exception. With more than 9,700 days of safety training last year, our employees are there to prevent emergency situations before they happen and ready to respond quickly and efficiently if their skills are required.

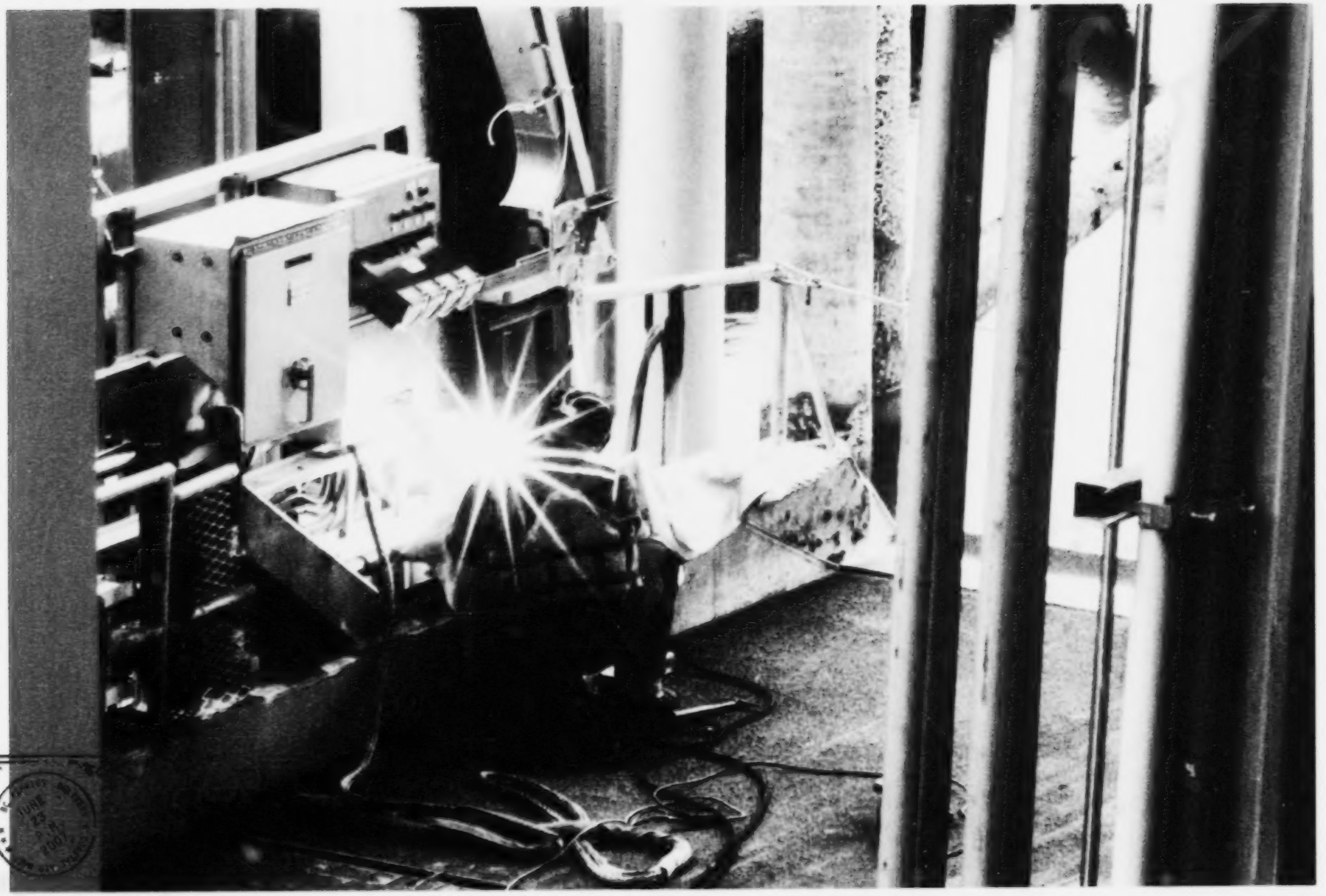
During the year, we continued to develop new and improved safety programs, including a company-wide program for all employees that will be further developed this year. We also provided additional safety training in key areas, revised our Voluntary Individual Safety Observation Reporting System, consolidated our Operations Safety Log, reviewed procedures for the introduction of new bridge electronics, and increased the level of safety management, accident prevention and incident investigation training. We also began a fleet-wide program to install Voyage Data Recorders (VDRs) on all new vessels and to retrofit the current fleet with VDRs within the next 18 months.

We developed Occupational First Aid Working Groups, added new Safety Officer positions and implemented an expanded training program for all occupational safety personnel. To ensure that employees are easily identifiable to our passengers at all times, we introduced a new uniform program and implemented photo security identification cards for all employees.

Security

We held regular meetings with Transport Canada to improve our relationship and reduce regulatory uncertainty, participated with other Canadian ferry operators and Transport Canada in establishing new security regulations, and met with the RCMP Integrated National Enforcement Team and Canadian Security and Intelligence Service. In October, we took part in the Canadian Coast Guard's SAREX 2006 Ship to Shore training exercise. Along with BC Ferries, various federal, provincial and local agencies participated in the day-long exercise that included simulated emergencies onboard the *Queen of Nanaimo*.

In November 2005, the Federal Minister of Transport announced that security regulations would be expanded to include domestic ferry operations. BC Ferries, along with other members of the Canadian Ferry Operators Association, has been working with Transport Canada on the design and implementation process. In preparation for the impending regulations, which are expected to be in place sometime in 2007, we have developed a company-wide security plan and are in the process of developing detailed security plans for each terminal and vessel. Through the Marine Security Contribution Program, we are eligible for reimbursement of $3.8 million in federal funding to offset the costs of perimeter security, access control measures and training for Swartz Bay, Tsawwassen, Departure Bay and Duke Point terminals.



16 Construction at Horseshoe Bay Terminal

Renewing Assets & Building New Ships

This past year, we invested all of our retained earnings in infrastructure to ensure the safety and operational reliability of our vessels, terminals and facilities.

Over the year, we completed 21 vessel refits, including a $38 million mid-life upgrade on the *Queen of Surrey*, and began a similar upgrade on the *Queen of Alberni*, which was completed in June 2007. In total, we invested $206 million in new vessels, vessel upgrades and modifications to improve the reliability of our fleet.

We purchased a replacement vessel, renamed the *Northern Adventure*, that entered service on our northern routes in March, and launched the *Kuper*, a vessel we purchased and re-constructed before it entered service on the Chemainus-Thetis-Kuper route.

The largest vessel replacement initiative in our company's history began with the construction of three new Super C-class ferries, the *Coastal Renaissance*, *Coastal Inspiration* and *Coastal Celebration*, and a new 125-car Intermediate class ferry. Adding to this important milestone, we awarded a $133 million contract for the construction of a new ferry, the *Northern Expedition*, that will enter service on the Inside Passage in spring 2009, bringing an exciting new travel experience to local and international customers travelling to the north coast of British Columbia onboard BC Ferries. By the summer of 2009, we will have added seven new vessels to our fleet—the first wave of a replacement strategy that will see 26 new ferries in service over the next 15 years.

While renewing our fleet is crucial to providing outstanding service, we must also ensure that our terminals can support our operations and provide the best in comfort and service for our customers. Over the past year, we made significant investments at Swartz Bay terminal, including the construction of a $24 million state-of-the-art floating berth and a new exit road to reduce traffic congestion and improve safety for our customers exiting the foot passenger area. The new berth, which allows for more efficient loading and unloading of vehicles, will accommodate the *Coastal Celebration* when it begins sailing the Swartz Bay–Tsawwassen route in 2008.

We began a $28 million project to replace marine structures at Departure Bay and Horseshoe Bay in order to accommodate the Super Cs, which are longer and wider than the C-class ships currently docking at these terminals. More than 20 B.C. companies are involved in the project. We are also investing an additional $35 million at Departure Bay to construct new retail and ticketing buildings, expand the holding compound and parking area, realign traffic flow and upgrade the waiting room.

We also invested $5 million in new marine structures at Alliford Bay, Buckley Bay, Chemainus, Gabriola, Kuper Island, Little River, Long Harbour and Saltery Bay, and began a $29 million project to modify docks at Port Hardy, Prince Rupert, Skidegate, McLoughlin Bay and Klemtu to accommodate our new northern fleet.

To ensure we make the best use of our facilities and properly plan for future expansion, we completed Terminal Master Plans for Departure Bay, Denman West, Buckley Bay and Kuper Island. In addition, we conducted archaeological assessments and consulted with First Nations prior to development at our terminals.

Operational Reliability continued

Our Environmental Commitment

As part of our commitment to the environment, we meet or exceed all applicable pollution prevention and abatement regulations and minimize our environmental footprint through a variety of initiatives.

As a result of our fuel consumption reduction strategy, we have reduced our annual fuel consumption by more than six million litres compared to the level of fuel consumed three years ago. We have continued to implement a wide variety of fuel saving measures, including resurfacing vessel hulls, installing new, more fuel-efficient engines on some of our vessels and fuel monitoring systems on others. To date, we have installed Electronic Speed Pilots (ESP) on four of our vessels, resulting in considerable fuel savings. This year, we expect to achieve further fuel savings through the installation of ESPs on seven more vessels.

We replaced our gasoline-powered baggage towing trucks on our major routes with nine propane-powered units to reduce Greenhouse Gas Emissions by approximately 15 per cent, and continued our successful organic composting program at the Departure Bay terminal and on the vessels operating between Departure Bay and Horseshoe Bay. This year we will expand the program, which diverts approximately 1,500 kg of compostable material from the landfill every week, to additional routes.

We continued our fleet-wide program to recycle used cooking oil, beverage containers, cardboard, newspaper and spent fluorescent tubes and batteries, as well as our Hazardous Waste Management program whereby oily wastes and spent solvent and paints are collected and processed by specialized companies. All oily waters generated onboard our vessels are either processed through the onboard Oily Water Separators or collected for disposal.

To ensure we are in compliance with current and upcoming regulatory requirements, we tested sewage effluent from vessels fitted with onboard marine sanitation devices and bilge water effluent from selected vessels. We conducted environmental audits at our terminals and initiated vessel engine emissions testing, and conducted a trial of new environmentally-friendly cleaning products onboard two vessels. This year, we will expand the use of these cleaning products to the rest of the fleet.

The *Canada Shipping Act's* Regulations for the Prevention of Pollution from Ships and for Dangerous Chemicals came into effect on June 1, 2007. The regulation, which applies to all Canadian ships, sets out new requirements for air emissions and sewage discharge standards. To ensure we are in full compliance with the regulations, all new or substantially rebuilt marine engines for our vessels are being designed to comply with the new regulations, and we are investing $21.4 million in a vessel sewage treatment program. Our shore-based sewage treatment systems are monitored monthly by third-party consultants and reported to the Ministry of Environment.

Taking a closer look at B.C.'s coast

20 "Grizzly Bear and Whale" by Master Carver Chief Henry Hunt at Swartz Bay Terminal

Before we hit the road today we checked out the BC Ferries website and found tons of great info — traffic conditions via webcams, reservations and even vessel-tracking maps.

Improving Everything We Do

Our commitment to excellence means we're always looking for ways to be better at everything we do. For us, there's no better way to see how we're doing than by talking to our customers and stakeholders.

Our 2006 Customer Satisfaction Survey told us that 89 per cent of our customers are satisfied with their BC Ferries travel experience, up from 86 per cent the previous year. In a 2003 study, 83 per cent of those surveyed had a favourable impression of BC Ferries. As with previous years, our employees consistently received high marks for their courtesy and professionalism, with travellers also giving high marks for operational safety, efficiency of ticket purchases, ease of using online reservations, usefulness of the website, highway signage, tourist information and the cleanliness of passenger waiting areas.

Throughout the year, we met regularly with local governments and consulted with our Ferry Advisory and Terminal Liaison Committees. Our Accessibility Advisory Committee continued working with the BC Coalition of People with Disabilities to increase accessibility for people with disabilities at our terminals and onboard our vessels. The Coalition's input has been particularly helpful as we design new vessels and develop master plans for our terminals.

We continued to add new features to improve our customers' travel experience, including installing an electronic message board on the Island Highway north of Nanaimo to provide real-time information about Duke Point and Departure Bay sailings. We upgraded our vessels and terminals to allow for significant enhancements to food, beverage and retail offerings, launched an automated ticketing system at Swartz Bay and Tsawwassen terminals, and added special late-night sailings to enable customers to return to Vancouver Island after BC Lions football games and the Steve Nash Foundation Charity Classic.

In recognition of the important role we play in British Columbia's coastal communities, we look for ways to give back to the communities we serve. As part of our sponsorship with Sport BC and KidSport™, we donated more than $63,000 last year to provide underprivileged kids an opportunity to participate in sport. In addition to sponsorships with the BC Lions, Salmon Kings and the Royal BC Museum, we were the presenting sponsor of the 2007 All Native Basketball Tournament in Prince Rupert. In December, we donated proceeds of approximately $325,000 from Christmas Day travel to 98 food banks throughout B.C.

During the year, we improved our business planning process to make it more rigorous and comprehensive and introduced expanded and refined performance metrics throughout the company to track improvements through a variety of indicators on an ongoing basis.

Continuous Improvement continued

Our Number One Asset

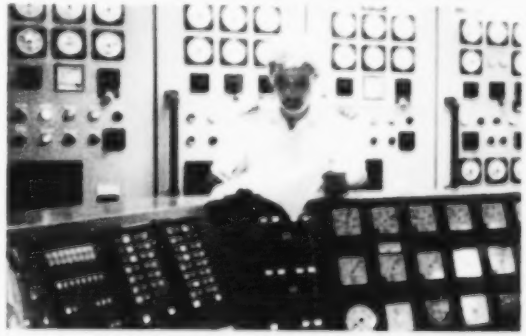
At BC Ferries, our employees are our number one asset. From ensuring the safe operation of our vessels and terminals to providing helpful travel advice and assisting customers with flat tires and lost keys, our employees are front and centre each and every day.

To ensure we continue to provide our employees with opportunities to grow and develop while maintaining the highest standards of performance and professionalism within our company, we implemented a comprehensive succession plan and extended our career and management development programs to offer more than 1,200 training days last year. Our employees also completed more than 9,700 days of safety training during the year.

Our Respect in the Workplace program was rolled out to ensure we promote and maintain a positive and progressive work environment for all employees. To further develop our employees' potential, we provided extensive professional development opportunities and financial support for continuing education through our education refund program. We continued plans to develop our own training institute, BC Ferries Academy, where we will provide world-class regulatory, safety and operational training, as well as best practice employee and management development programs, to our employees.

In March 2007, we finalized a new Collective Agreement with the BC Ferry & Marine Workers' Union. The new agreement, which is in effect through October 31, 2012, clearly focuses on the interests of customers and British Columbians by extending the length of the term and incorporating a unique and innovative dispute resolution process that will facilitate future collective bargaining.

We look forward to a positive and productive relationship with all of our employees for many years to come.



22 BC Ferries employees hard at work

BC Ferries crew member at Tsawwassen Terminal

Today's our lucky day! First we got a super promo deal on our fare and then we got a really cool (and free!) presentation about B.C. onboard the ship.

A Focus On Service

A journey onboard BC Ferries is about more than just riding a ferry. It's about providing the best service at the best value for all of our customers.

Throughout the year, we offered various promotions and travel incentives for seniors, families and commercial customers. We launched a new fare program, the COASTSAVER Sailing Program, which offers savings of up to 40 per cent when travelling on specified sailings. During the summer months, customers onboard our major route sailings were offered an enhanced west coast travel experience through the Coastal Naturalist program – a series of informative onboard presentations about the geography, wildlife and spectacular scenery B.C. has to offer.

Exploring Alternative Service Providers

The *Coastal Ferry Act* requires BC Ferries to seek additional or alternative service providers on designated routes through fair and open competitive processes. Accordingly, we have filed an Alternative Service Providers Plan with the BC Ferries Commissioner that sets out the specific routes where we will consider alternative service delivery options during the first performance term of the Coastal Ferry Services Contract.

In February 2007, we issued a Request for Proposals on the Brentwood Bay-Mill Bay route to two proponents. The closing date was June 15, 2007 and we expect to make a decision whether to proceed with an alternative service provider on this route by the end of December 2007. We are also working with a potential alternative service provider regarding a possible pilot project for the Buckley Bay-Denman Island and Hornby Island-Denman Island routes and expect to issue a Request for Proposals regarding the operation of our routes north of Port Hardy; however, the timing of this request is uncertain.

Expanding Our Business

In February, we signed a 40-year lease with the Town of Surrey, under which we will manage and develop the Town's ferry terminal to the benefit of both parties. Washington State Ferries will continue to remain the priority user of the terminal with its service to Anacortes, Washington. In accordance with the lease contract, we will assume management of the facility in September 2007 and will focus on developing innovative new business opportunities for BC Ferries and the communities we serve. In consultation with the Town, we will develop a master plan for future development of the terminal.

Value For Money

A Focus On Service

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Exploring Alternative Service Providers

The *Coastal Ferry Act* requires BC Ferries to seek additional or alternative service providers on designated routes through fair and open competitive processes. Accordingly, we have filed an Alternative Service Providers Plan with the BC Ferries Commissioner that sets out the specific routes where we will consider alternative service delivery options during the first performance term of the Coastal Ferry Services Contract.

In February 2007, we issued a Request for Proposals on the Brentwood Bay-Mill Bay route to two proponents. The closing date was June 15, 2007 and we expect to make a decision whether to proceed with an alternative service provider on this route by the end of December 2007. We are also working with a potential alternative service provider regarding a possible pilot project for the Buckley Bay-Denman Island and Hornby Island-Denman Island routes and expect to issue a Request for Proposals regarding the operation of the routes north of Port Hardy; however, the timing of this request is uncertain.

Expanding Our Business

In February, we signed a 40-year lease with the Town of Sidney, under which we will manage and develop the town's ferry terminal to the benefit of both parties. Washington State Ferries will continue to remain the priority user of the terminal with its service to Anacortes, Washington. In accordance with the lease contract, we will assume management of the facility in September 2007 and will focus on developing innovative new business opportunities for BC Ferries and the communities we serve. In consultation with the Town, we will develop a master plan for future development of the terminal.

Catching a glimpse of the Gulf Islands

Conference Room

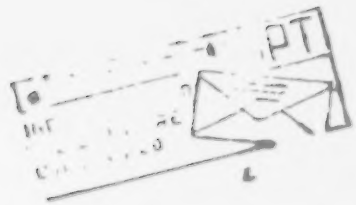
Beautifully appointed at the forward end of our ships, our Conference Rooms offer sweeping views of passing scenery while allowing our business travellers to work privately onboard. The Spirit-class ships seat up to 20 people and the *Queen of Nanaimo* up to 12 people.

Passages Gift Shop

The Passages Gift Shop provides everything from seasonal apparel and contemporary giftware to BC Ferries toys, as well as a large selection of books and magazines. Our customers can also shop online at www.bcferries.com.

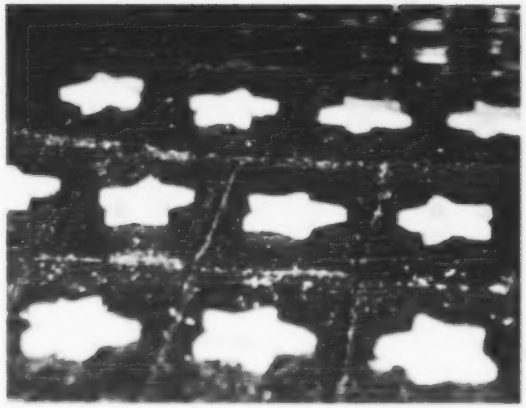
Play Area

While riding the ferries can be an exciting experience in itself for our younger travellers, play areas are provided outdoors at select terminals and in the KidZone areas onboard some vessels. With slides, cars and flat-screen televisions for children's programming, visiting the KidZone is one great way to keep children occupied and entertained.



Seawest Lounge

The Seawest Lounge provides a value-added service onboard the Spirit-class ships. Here, travellers can catch up on some work, read a book or simply relax and enjoy the spectacular scenery. With Starbucks Coffee, tea, juices, pastries and a choice of newspapers and magazines for one all-inclusive price, the Seawest lounge is another way for our customers to enjoy the trip between Vancouver and Victoria.



Food Services

A wide variety of food and beverage options are available onboard our vessels and at our terminals. In the Coastal Café, choose from White Spot Triple O burgers and fries, Bread Garden sandwiches or favourites from the BC Ferries Coastal Sensations menu featuring salmon, prawns, ribs and pasta. The Lighthouse Café on the *Northern Adventure* offers a truly spectacular outdoor dining experience on sailings from Port Hardy to Prince Rupert.

Pacific Buffet

The Pacific Buffet offers elegant ocean-view dining on sailings from Vancouver to Victoria and features a wide selection of hot and cold items, salads, desserts and more for one all-inclusive price. Selections range from traditional breakfast fare to dim sum, roast turkey, eggplant Parmigiano and our famous clam chowder, depending on time of travel.

Financial Integrity

Meeting Our Financial Targets

Achieving our financial targets ensures we have the capital and retained earnings we need to revitalize our fleet, facilities and infrastructure, while keeping fares at affordable levels for our customers.

This past year, we posted net earnings before extraordinary gain of $48.8 million, down from $49.9 million the previous year. We also completed a detailed evaluation of our internal controls over financial reporting processes to meet Canadian securities regulations and completed a successful issue of 30-year bonds totalling $250 million at 5.021 per cent.

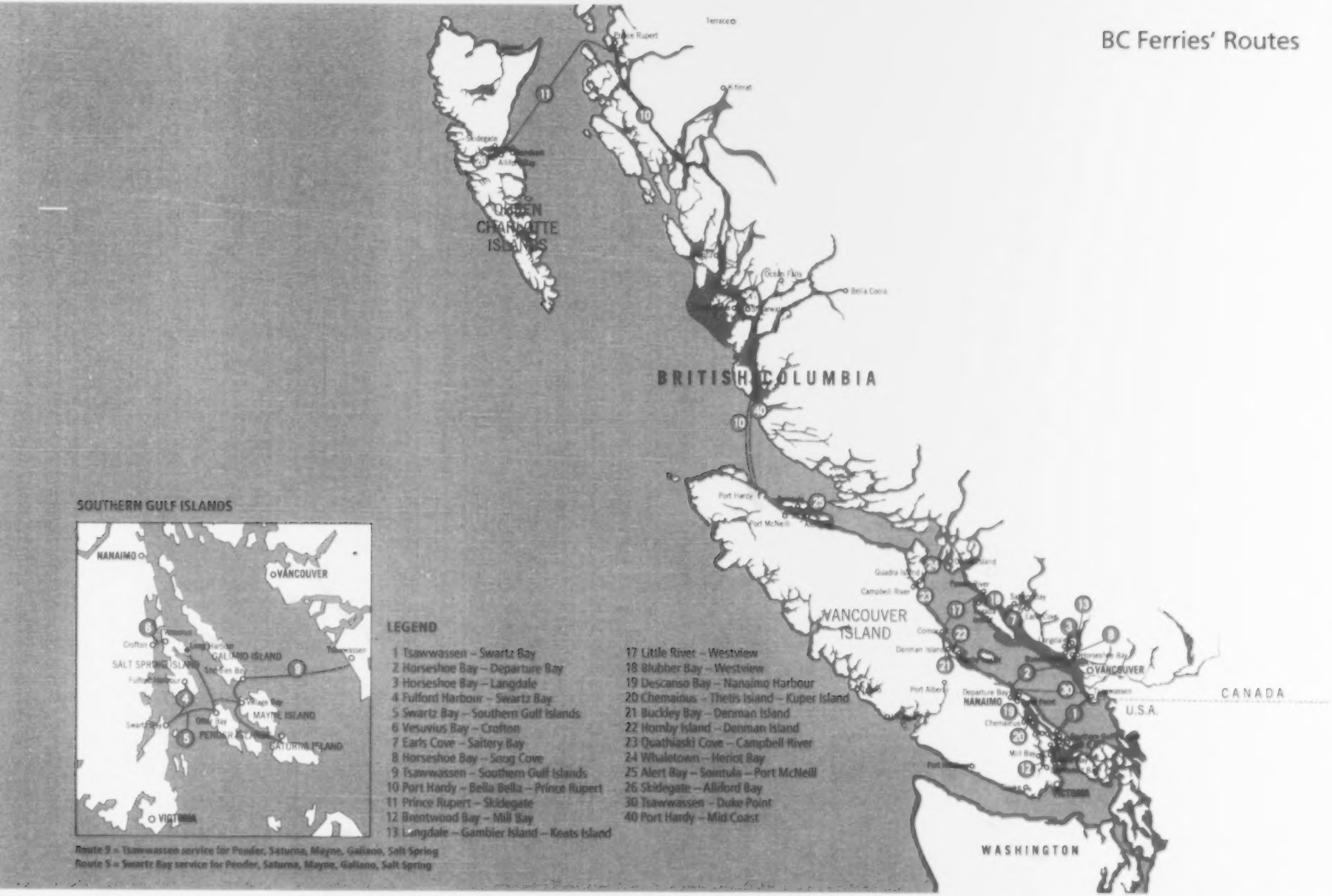
Our capital investment in our fleet, terminals and information systems totalled $262.6 million, including $206.0 million in new vessels, vessel upgrades and modifications, $38.0 million in marine structures, $11.6 million in terminal and building upgrades, and $6.9 million in software development to enhance customer services and operational efficiency.

In September, in accordance with Section 40 of the *Coastal Ferry Act*, we made our Performance Term Two submission to the BC Ferries Commissioner, which is being used in the Commissioner's review and setting of fare caps for the period April 1, 2008 - March 31, 2012. The Commissioner is required to establish price caps and monitor service levels for designated ferry route groups and undertakes this regulation in accordance with several principles, including placing priority on the financial sustainability of the ferry system, encouraging a commercial approach to ferry service delivery and moving to a greater reliance on a user-pay system over time.

In March, the Commissioner provided his preliminary price caps to BC Ferries and the Province of British Columbia and released the information to the public. The provincial government has until June 30, 2007 to decide whether it wants to make amendments to the Coastal Ferry Services Contract to reflect changes in core service levels or service fees for Performance Term Two. The Commissioner will consider any amendments approved by the provincial government before releasing a final ruling on price caps by September 30, 2007.

The Spirit of Vancouver Island

BC Ferries' Routes

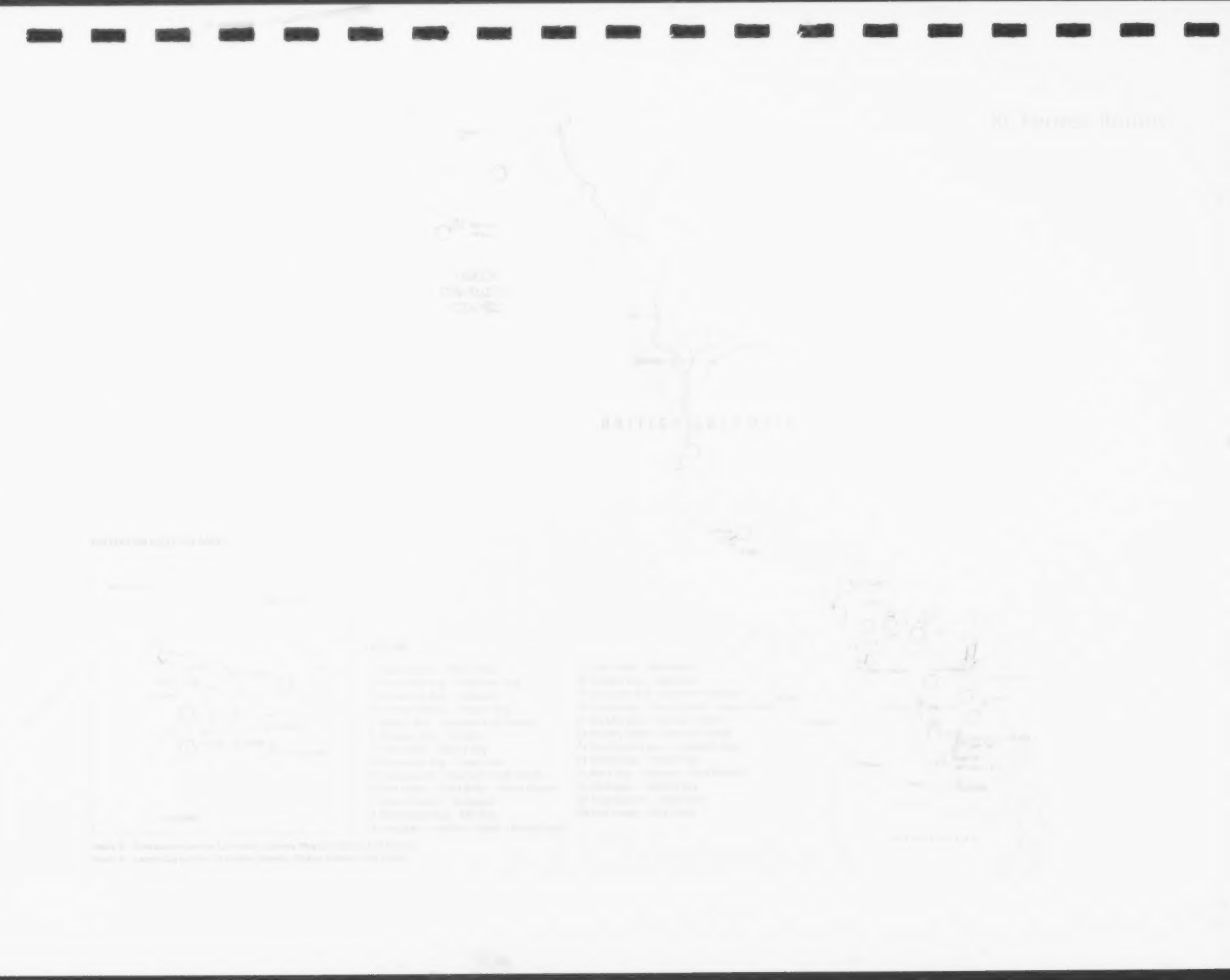


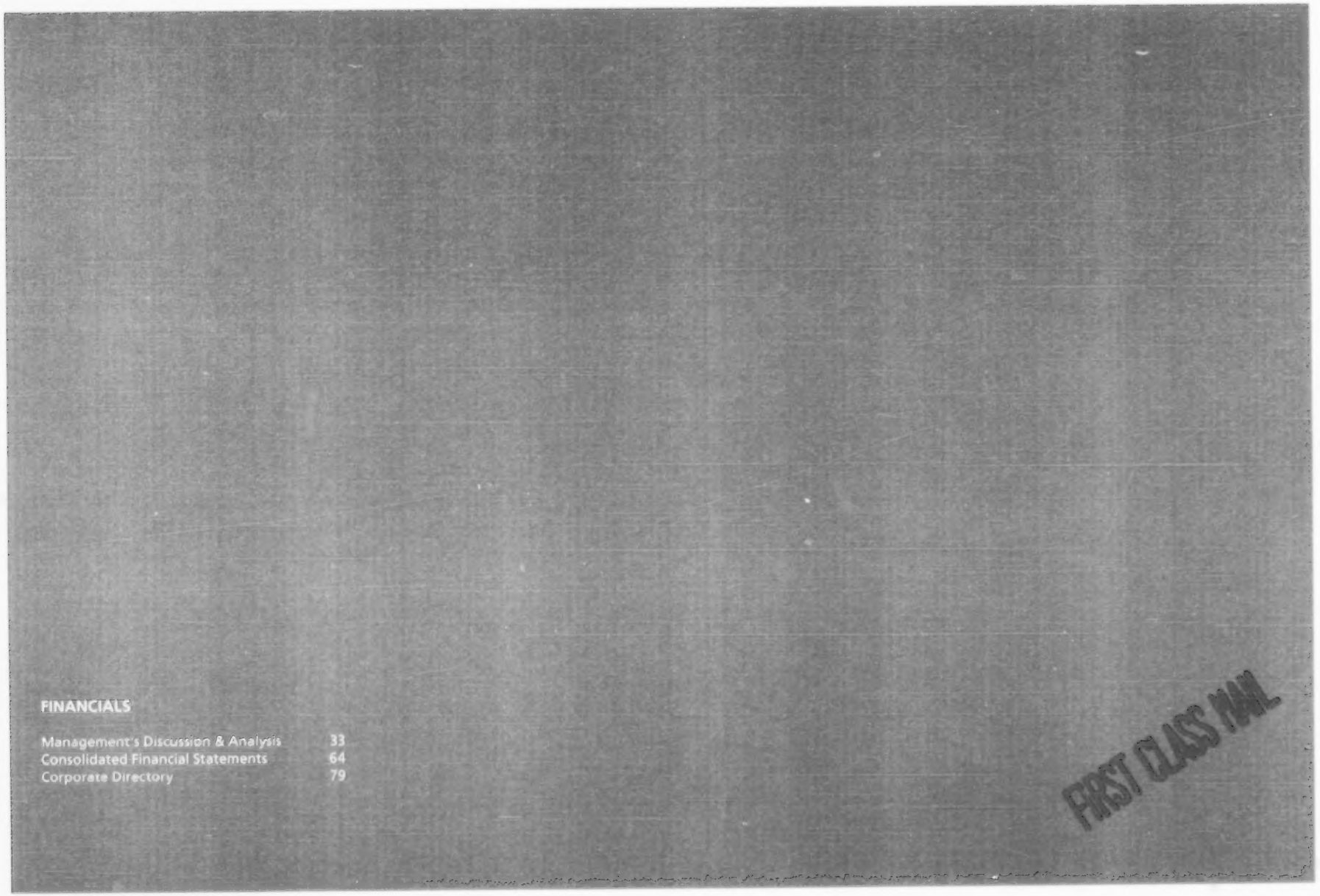
SOUTHERN GULF ISLANDS

LEGEND

1 Tsawwassen – Swartz Bay
2 Horseshoe Bay – Departure Bay
3 Horseshoe Bay – Langdale
4 Fulford Harbour – Swartz Bay
5 Swartz Bay – Southern Gulf Islands
6 Vesuvius Bay – Crofton
7 Earls Cove – Saltery Bay
8 Horseshoe Bay – Snug Cove
9 Tsawwassen – Southern Gulf Islands
10 Port Hardy – Bella Bella – Prince Rupert
11 Prince Rupert – Skidegate
12 Brentwood Bay – Mill Bay
13 Langdale – Gambier Island – Keats Island
17 Little River – Westview
18 Blubber Bay – Westview
19 Descanso Bay – Nanaimo Harbour
20 Chemainus – Thetis Island – Kuper Island
21 Buckley Bay – Denman Island
22 Hornby Island – Denman Island
23 Quathiaski Cove – Campbell River
24 Whaletown – Heriot Bay
25 Alert Bay – Sointula – Port McNeill
26 Skidegate – Alliford Bay
30 Tsawwassen – Duke Point
40 Port Hardy – Mid Coast

Route 9 = Tsawwassen service for Pender, Saturna, Mayne, Galiano, Salt Spring
Route 5 = Swartz Bay service for Pender, Saturna, Mayne, Galiano, Salt Spring





FINANCIALS

Management's Discussion & Analysis	33
Consolidated Financial Statements	64
Corporate Directory	79

Management's Discussion & Analysis of Financial Condition and Results of Operations for the fiscal year ended March 31, 2007.

Dated May 16, 2007

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of May 16, 2007. This should be read in conjunction with our audited consolidated financial statements and related notes for the years ended March 31, 2007 (fiscal 2007) and March 31, 2006 (fiscal 2006). This management's discussion and analysis has been prepared based on information available at May 16, 2007, except where otherwise indicated. These documents are available on SEDAR at **www.sedar.com**.

Except where indicated, all financial information herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles.

BUSINESS OVERVIEW

British Columbia Ferry Services Inc. is an independent company providing ferry services on the west coast of British Columbia. We operate one of the largest and most complex ferry systems in the world, providing frequent year-round transportation service on 25 routes, supported by 36 vessels and 47 terminals. Our service is an integral part of British Columbia's coastal transportation system, and has been designated by the Province of British Columbia (the "Province") as an essential service for purposes of the provincial Labour Relations Code. This designation means our services are considered necessary for the protection of the health, safety and welfare of the residents of BC.

We are a versatile company, providing a wide range of ferry services for our customers. In fiscal 2007, we provided over 188,000 sailings, carrying over 21 million passengers and 8 million vehicles.

Significant events during or subsequent to fiscal 2007:

New Vessels (See "Investing in our Capital Assets" below for more detail)

- In April 2007, the first of three Super C-class vessels, the *Coastal Renaissance*, was launched. Construction of the Coastal Inspiration commenced in November 2006 while construction of the Coastal Celebration began in April 2007. These vessels will be the largest double-ended ferries in the world, with each vessel measuring 160-metres in length and having a capacity of 1,650 passengers and 370 vehicles. These new ships will replace aging vessels which currently provide service on our major routes. The *Coastal Renaissance* is expected to be in service in early 2008 while delivery of the other two Super C-class vessels is expected in early and mid 2008, respectively. The total project budget for the three vessels is $542 million.
- In March 2007, a new addition to our fleet, the *Kuper*, went into service on our smaller island routes. The total cost of this 32-vehicle ferry was $12 million.
- In March 2007, the *Northern Adventure* went into service on our northern routes. This vessel, measuring 117-metres in length, has 74 state rooms and will accommodate over 600 passengers and 101 vehicles. The total project budget for the acquisition and modification of the *Northern Adventure* is $102 million.
- In December 2006, the keel was laid for a new intermediate class ferry. This new vessel will allow for the retirement of the 47-year-old *Queen of Tsawwassen*. Once complete, the vessel will measure 100-metres in length and have a capacity of 600 passengers and 125 vehicles. The total project budget for this new vessel is $57 million. The vessel is expected to be in service by the summer of 2008.
- In August 2006, we signed a $133 million contract with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany to build the *Northern Expedition* to replace the 41-year-old *Queen of Prince Rupert*, operating on our northern routes. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 55 staterooms and will accommodate 130 vehicles and 600 passengers. The total project budget for this vessel is $200 million.

Other items:

- In March 2007 and after more than three years of negotiation, mediation and finally, arbitration, a new collective agreement with our employees was finalized and the term extended. The final award included a $1,000 lump sum payment to employees and wage increases for the next three years, and provides a basis for enhanced operational flexibility. See "Expenses – Year to Year Comparison of Expenses 2007-2006" below for more detail.
- In March 2007, the Commissioner released the preliminary price caps for the second performance term. In his preliminary decision, the Commissioner indicated that the price cap increase on April 1, 2008 will be 5.4% on the major routes and 3.6% on the other routes. See "Corporate Structure – Coastal Ferry Services Contract" for more detail.
- In March 2007, we closed a $250 million senior secured bond issue by private placement. The net proceeds will be used primarily to repay our credit facility, to fund capital expenditures and for general corporate purposes. See "Long-Term Debt" below for more detail.
- In March 2007, a fiscal 2007 ferry service fee reduction of $0.9 million was negotiated with the Province relating to the summer replacement service on our northern routes following the loss of the Queen of the North. In addition, the Province committed to a one-time $7.0 million additional service fee to be applied to fuel cost deferral accounts as at March 31, 2007.
- In January 2007, we received the final report from the independent review of our safety policies, procedures and practices. The report makes 41 recommendations on safety enhancements which we are implementing. See "Risk Management" below for more detail.
- In March 2006, the *Queen of the North*, operating on its regular route from Prince Rupert to Port Hardy, ran aground on Gil Island in Wright Sound and subsequently sank in 425 metres of water. Our divisional inquiry, released March 26, 2007, concluded that human factors were the primary cause of the incident but noted that the activities on the bridge during the last fourteen minutes before the grounding were unknown. Subsequently, additional information has been obtained and our divisional inquiry has been reconvened. The Transportation Safety Board and the RCMP investigations are ongoing. See "Northern Service" below for further detail.

CORPORATE STRUCTURE

Coastal Ferry Services Contract

We operate ferry services under a regulatory regime as defined by the *Coastal Ferry Act*, and under the terms set out in the Coastal Ferry Services Contract. This 60-year services contract with the Province, which commenced April 1, 2003, stipulates the number of round trips that must be provided for each regulated ferry service route in exchange for specified fees. In anticipation of the deployment of new vessels on our northern routes, higher ferry service fees have been negotiated with the Province for fiscal 2008, the final year of the first performance term of the contract. See "Northern Service" below for further detail. The Coastal Ferry Services Contract also includes fees for the provision of specific social program services delivered on behalf of the Province.

In March 2007, the Commissioner released the preliminary price caps for the second performance term covering fiscal 2009 through fiscal 2012. In his preliminary decision, the Commissioner indicated that the price cap increases on April 1, 2008, will be 5.4% on the major routes and 3.6% on the other routes. Subsequent annual changes in the price caps will depend on inflation. On each April 1 for the subsequent three years, the increase would be 2.0% plus CPI times .5 on the major routes and 5.2% plus CPI times .73 on all other designated routes. We are currently in negotiations with the Province on revisions to the Coastal Ferry Services Contract for the second performance term. The results of these negotiations will be provided to the Commissioner by June 30, 2007. The Commissioner will then provide the final decision on price caps for the second performance term by September 30, 2007.

Under the terms of the Coastal Ferry Services Contract, we also receive an annual amount from the Province based on its agreement with the Government of Canada to fulfill the obligation of providing ferry services to coastal British Columbia. The amount of this payment is adjusted annually based on the Vancouver Consumer Price Index.

Economic Regulatory Environment

The office of the British Columbia Ferries Commissioner (the "Commissioner") was created under the *Coastal Ferry Act*, enacted by the Province on April 1, 2003. The Commissioner regulates price caps for designated ferry route groups which, to the end of the first performance term, are specified in the *Coastal Ferry Act*. The Commissioner is also responsible for regulating the reduction of service, discontinuance of routes and certain other matters. The *Coastal Ferry Act* requires the Commissioner to undertake regulation in accordance with several principles, including placing priority on the financial sustainability of ferry operators, encouraging ferry operators to adopt a commercial approach to ferry service delivery and moving over time to a greater reliance on a user pay system.

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance over the past three fiscal years.

Year ended March 31 ($ millions)	2007	2006	2005
Total revenue	596.3	579.2	564.5
% Growth	3.0%	2.6%	5.8%
Expenses	(528.4)	(504.1)	(499.5)
Earnings from operations	67.9	75.1	65.0
Interest and other	(19.1)	(25.2)	(25.2)
Net earnings before extraordinary gain	48.8	49.9	39.8
Extraordinary gain	61.3	-	-
Net earnings	110.1	49.9	39.8

As at March 31	2007	2006	2005
Total assets	1,215.8	833.7	763.4
Total long-term financial liabilities	766.3	516.5	516.6
Cash dividends	6.0	6.0	6.0

Our consolidated net earnings before extraordinary gain in fiscal 2007 were $1.1 million or 2.2% lower than the previous fiscal year. Our earnings in fiscal 2006 grew $10.1 million or 25.4% from fiscal 2005. The extraordinary gain of $61.3 million in fiscal 2007 is as a result of insurance proceeds resulting from the loss of the *Queen of the North* as described below.

Northern Service

On March 22, 2006 the *Queen of the North*, operating on its regular route from Prince Rupert to Port Hardy, ran aground on Gil Island in Wright Sound and subsequently sank. Two passengers remain unaccounted for and are presumed to have perished.

An emergency environmental plan was implemented in conjunction with external authorities, including members of the Regional Environmental Emergency Team ("REET"). Burrard Clean Operations, under contract to us, led the containment activities at the incident site using 1,800 metres of barrier boom to protect sensitive areas. We have been monitoring the incident site for leakage of oil and, in consultation with REET, completed an extensive monitoring program. This has determined that the level of contaminants is very low in edible organisms, including shellfish, in the area of the wreck and that there is no risk for human consumption. In conjunction with our commercial insurer, we have investigated the feasibility and risk of recovering any fuel and lubricants that may remain in the vessel. We have provided the results of these investigations, along with various environmental studies, to the Canadian Coast Guard ("CCG"), which has engaged additional experts to extend its analysis of the issues. The CCG conclusions are that a significant amount of the fuel and lubricants were released following the incident, that a recovery operation would be exploratory at best, and it is probable that there is no recoverable fuel remaining on the vessel. As a result, we have determined not to pursue fuel and lubricant recovery from the incident site. We will continue to monitor the site for leakage of oil.

The Transportation Safety Board, as the lead investigation agency, along with Transport Canada and the RCMP, are conducting independent investigations related to the sinking. Our divisional inquiry, released March 26, 2007, concluded that human factors were the primary cause of the incident but noted that the activities on the bridge during the last fourteen minutes before the grounding were unknown. The divisional inquiry report also made 31 recommendations on equipment, bridge team, and emergency and evacuation procedures. Some of these recommendations have already been implemented and the remainder are in progress. Subsequently, additional information has been obtained and our divisional inquiry has been reconvened. The Transportation Safety Board and the RCMP investigations are ongoing.

A tug and barge service, as well as air service, was used as an interim measure to ensure that supplies reached the Queen Charlotte Islands and passengers requiring passage were accommodated. For the busy summer period, we augmented service provided by the *Queen of Prince Rupert* with additional tug and barge and air service.

We maintain commercial insurance coverage for incidents of this nature. Insurance proceeds, net of deductible, of $67.9 million were received in May 2006 in settlement of the claim under the hull and machinery policy. In accordance with generally accepted accounting principles, $6.6 million of the insurance proceeds were recorded as a receivable to offset insurable losses in fiscal 2006. We reported an extraordinary gain of $61.3 million for this event in the first quarter of fiscal 2007. These funds are being utilized to partially fund the acquisition of the *Northern Adventure*. Claims for personal belongings of passengers and passenger automobiles are substantially complete. Other types of claims are still in progress. We expect that substantially all passenger claims, claims from other parties and costs incurred for environmental containment or cleanup will be paid by our liability insurer.

Our hull and machinery insurance policies were subsequently renewed with an increase in annual premium costs of approximately $1.5 million. This was more than offset this year by $3.2 million of interest income earned and avoided interest costs on invested insurance proceeds. We have recorded a liability at March 31, 2007 to reflect the requirement to repay the Province $0.9 million representing the negotiated reduction in ferry service fees regarding the lower level of summer replacement service we provided.

In March 2007, the *Northern Adventure*, a replacement for the *Queen of the North*, went into service on our northern routes. The two-year-old vessel was purchased in October 2006 and underwent significant modifications to update safety and security equipment, modify the stern to be compatible with our existing berths, upgrade electrical, heating and lighting systems and upgrade customer amenities. This 117-metre vessel has 74 state rooms and will accommodate over 600 passengers and 101 vehicles. See "Investing in our Capital Assets" below for more detail.

In August 2006, we signed a $133 million contract with FSG to build the *Northern Expedition* to replace the 41-year-old *Queen of Prince Rupert*, operating on our northern routes. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 55 staterooms and will accommodate 130 vehicles and 600 passengers. See "Investing in our Capital Assets" below for more detail.

Negotiations with the Province have concluded, resulting in increases to future service fees to support the deployment of these two vessels on the northern routes. Service fees will increase by approximately $13 million commencing in fiscal 2008, with a further increase of approximately $22 million annually upon the entry into service of the *Northern Expedition*.

We anticipate a third replacement vessel for the northern service will be acquired and commence operating during our next performance term. Negotiations with the Provincial government for increased service fees with respect to this vessel are ongoing.

Revenue

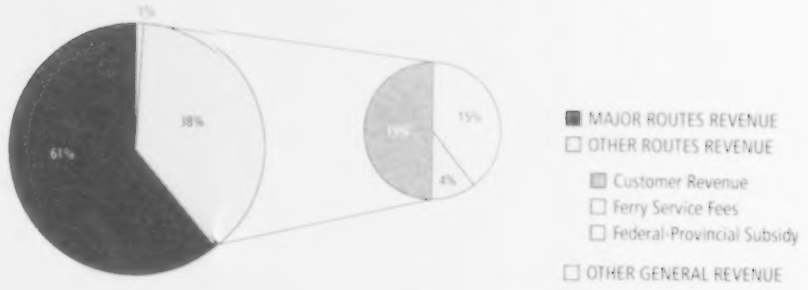
Our total revenues have increased steadily over the past three fiscal years, as shown in the table below.

Year ended March 31 ($ millions)	2007	2006	2005
Direct Route Revenue			
Tariff - vehicles	227.3	221.5	216.5
Tariff - passengers	135.9	132.1	129.4
Social program fees	16.0	14.7	13.4
Catering & on-board	71.0	66.9	65.9
Other revenue	23.5	21.0	17.2
Total Direct Route Revenue	473.7	456.2	442.4
Indirect Route Revenue			
Ferry services fees	92.4	93.5	93.6
Federal-Provincial subsidy	25.3	24.9	24.3
Total Route Revenue	591.4	574.6	560.3
Other general revenue	4.9	4.6	4.2
Total Revenue	596.3	579.2	564.5

Our largest revenue source is vehicle and passenger tariffs. The annual average tariff rate increase was 2.8% on our three major routes and 4.4% on the remaining routes, as permitted by the *Coastal Ferry Act*. From time to time we utilize promotional fare reductions designed to stimulate growth in traffic levels or shift traffic away from our busiest sailings.

The greatest portion of our revenues, 61%, is earned on our three major routes connecting Vancouver Island to the lower mainland and Vancouver and is entirely direct revenue from customers and related social program fees. The revenue from the other routes makes up 38% while other general revenue consisting of marketing rights, advertising revenues, interest earned and net foreign exchange gains, is only 1% of the total revenue.

The revenue from our other routes consists of 19% from customers and related social program fees, 15% from ferry service fees and 4% from payments under the Federal-Provincial subsidy agreement.



Revenue

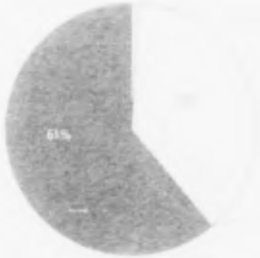
Our total revenues have increased steadily over the past three fiscal years, as shown in the table below.

Year ended March 31 ($ millions)	2007	2006	2005
Direct Route Revenue			
Tariff – vehicles	227.1	221.5	216.5
Tariff – passengers	135.9	132.1	129.4
Social program fees	16.0	16.7	13.4
Catering & on board	71.0	66.9	65.9
Other revenue	21.5	21.0	17.2
Total Direct Route Revenue	471.7	458.2	442.4
Indirect Route Revenue			
Ferry services fees	97.8	93.5	93.6
Federal Provincial subsidy	25.1	24.9	24.3
Total Route Revenue	594.4	576.6	560.3
Other ground revenue	4.9	4.6	4.2
Total Revenue	599.3	581.2	564.5

Our largest revenue source is vehicle and passenger fares (79). The annual average fare increase was 2.8% on our three major routes and 4.4% on the remaining routes, as provided by the Coastal Ferry Act. From time to time, we offer discounted fare collections designed to increase growth in traffic levels or shift traffic away from our busiest sailings.

The greatest portion of our revenue, 65%, is earned on our three major routes. Revenue is recognized when the related transportation service is provided. Direct revenue from customers contracted on a program fee. The expenses from the other routes are 36% while other revenue consisting of catering, rental, advertising revenue, vessel charter and charge (8%), totaling 1% of the total revenue.

The revenue from our other routes consists of fees from customers and charter vessel program fees. Indirect ferry service fees are 43% from payments under the Federal Provincial subsidy agreement.



■ Major routes Revenue
□ Other routes Revenue

□ Catering Revenue
□ Ferry service fees
□ Federal Provincial Subsidy

□ Other General Revenue

Management's Discussion & Analysis

Year to year changes for the past two fiscal years for major and other routes are discussed separately below.

Year to Year Comparison of Revenues 2007 – 2006

Major Routes

Fiscal year ended March 31 ($000's)	2007	2006	Increase (Decrease)	
Direct Route Revenue				
Vehicle traffic (volume)	3,826,459	3,790,368	36,091	1.0%
Vehicle tariff	171,998	167,451	4,547	2.7%
Passenger traffic (volume)	11,146,311	11,055,858	90,453	0.8%
Passenger tariff	101,300	97,029	4,271	4.4%
Social program fees	8,284	7,789	495	6.4%
Catering & on-board	59,009	54,516	4,493	8.2%
Reservation fees	12,389	11,581	808	7.0%
Parking	2,864	2,621	243	9.3%
Assured loading	2,075	1,544	531	34.4%
Other revenue	4,058	2,728	1,330	48.8%
Total Direct Route Revenue	361,977	345,259	16,718	4.8%
Retail gross margin	35,536	32,415	3,121	9.6%

Vehicle traffic and passenger traffic increased marginally. The increase in average tariff per vehicle was $0.77 while the increase in average tariff per passenger was $0.31. The increased traffic and higher average fares resulted in a total increase of $8.8 million in tariff revenue.

Social program fees are reimbursements from the Province of discounts provided on fares for BC seniors, students traveling to and from school, persons with disabilities and persons traveling under the medical Travel Assistance Program. These fees have increased as a result of higher program usage and higher fares.

All of our vessels that provide service on our major routes have a gift shop and options for food service. Food sales increased $3.1 million as a result of higher spending per passenger and the higher number of passengers carried. Gift shop sales increased $0.9 million with significant improvements in sales of books, clothing and giftware. Eighty percent of the book titles we carry are BC related. We introduced new apparel and gift products which have met with success. We have been able to achieve higher sales while increasing margins.

Fees for reservations, parking commissions and surcharges from assured loading ticket sales are also showing a marked increase as a result of both increased prices and increased usage.

In May 2005, we ceased sales of paper assured loading tickets and implemented the Coast Card[1]. A $3.1 million reduction of our deferred revenue liability relating to historical sales of paper tickets was made in fiscal 2007 ($2.0 million in fiscal 2006) and is included in other customer revenue in the above table.

[1] *A plastic stored-value card with a magnetic strip, similar to a bank card. Assured loading tickets are offered on the card. In the future other services may be available through this card.*

Other Routes

Fiscal year ended March 31 ($000's)	2007	2006	Increase (Decrease)	
Direct Route Revenue				
Vehicle traffic (volume)	4,695,456	4,752,901	(57,445)	(1.2%)
Vehicle tariff	55,313	54,035	1,278	2.4%
Passenger traffic (volume)	10,518,642	10,673,745	(155,103)	(1.5%)
Passenger tariff	34,617	35,110	(493)	(1.4%)
Social program fees	7,683	6,885	798	11.6%
Catering & on-board	11,997	12,442	(445)	(3.6%)
Reservation fees	1,257	1,062	195	18.4%
Stateroom rental	367	1,024	(657)	(64.2%)
Parking	217	174	43	24.7%
Other revenue	302	276	26	9.4%
Total Direct Route Revenue	111,753	111,008	745	0.7%
Indirect Route Revenue				
Ferry service fees	92,429	93,549	(1,120)	(1.2%)
Federal-Provincial subsidy	25,309	24,890	419	1.7%
Total Route Revenue	229,491	229,447	44	0.0%
Retail gross margin	7,244	7,566	(322)	(4.3%)

Our other routes consist of 22 regulated northern service and inter-island routes, and eight small non-regulated routes. One of the regulated routes, as well as all of the non-regulated routes, are operated under contract by alternative service providers. We receive fees from the Province for the provision of service on the non-regulated routes, which are included in the ferry service fees in the above table.

Twenty-one percent of the vehicle traffic decrease and 26.7% of the passenger traffic decrease is directly related to the loss of the *Queen of the North*. The negative effect on tariff revenue resulting from this incident is approximately $2.2 million in vehicle tariff revenue and $2.5 million in passenger tariff revenue.

The increase in average tariff per vehicle was $0.41 while the average passenger tariff did not change. The increased average vehicle fare, partially offset by the reduction in traffic levels on the northern and other routes limited the total tariff revenue increase to $0.8 million.

We receive ferry service fees for these routes under the Coastal Ferry Services Contract. The drop in fees reflects the negotiated reduction of $0.9 million resulting from the modified summer service we provided as a result of the loss of the *Queen of the North*.

Reimbursements from the Province for social program fees increased as a result of higher program usage and higher fares.

The loss of the regular northern service throughout the summer months resulted in a decrease in retail sales of approximately $1.2 million. This was partially offset by higher food sales per passenger on other routes and additional sales from an expanded gift shop on the *Queen of Surrey*, which operates between Horseshoe Bay and Langdale.

The drop in stateroom rental is also as a result of the modified service on the northern routes over the summer months. Gross margin is 4.3% lower mainly due to higher costs on our northern routes.

Fees for reservations, parking commissions and other revenue have shown a marked percentage increase, despite the limited northern service during the summer months.

Year to Year Comparison of Revenues 2006 – 2005

Major Routes

Fiscal year ended March 31 ($000's)	2006	2005	Increase (Decrease)	
Direct Route Revenue				
Vehicle traffic (volume)	3,790,368	3,808,843	(18,475)	(0.5%)
Vehicle tariff	167,451	164,043	3,408	2.1%
Passenger traffic (volume)	11,055,858	11,222,356	(166,498)	(1.5%)
Passenger tariff	97,029	95,558	1,471	1.5%
Social program fees	7,789	7,259	530	7.3%
Catering & on-board	54,516	54,098	418	0.8%
Reservation fees	11,581	10,349	1,232	11.9%
Parking	2,621	2,477	144	5.8%
Assured loading	1,544	1,103	441	40.0%
Other revenue	2,728	992	1,736	175.0%
Total Direct Route Revenue	345,259	335,879	9,380	2.8%
Retail gross margin	32,415	32,255	163	0.5%

Vehicle and passenger traffic both decreased marginally. A portion of the decrease is a result of timing of the Easter weekend. In fiscal 2005, we experienced two Easter weekends while fiscal 2006 did not include any. We also witnessed a decrease in the number of tour buses which we believe was related to a decline in tourism. This is more evident on our major routes which experience the greatest volatility from changes in tourism. The increase in average tariff per vehicle was $1.11 while the increase in average tariff per passenger was $0.26. Despite lower traffic levels, tariff revenues increased $4.9 million.

Reimbursements from the Province for social program fees increased as a result of higher program usage and higher fares.

Retail revenue, which includes food and other retail merchandise sales, experienced growth which was partly attributed to the addition of the new Seawest Lounge on the *Spirit of British Columbia*.

The increase in reservations fees reflects a higher number of reservations placed and a higher fee for booking within the week of travelling implemented in the third quarter of fiscal 2006.

The increase in revenue from assured loading sales reflects both higher usage and higher fees.

With the implementation of the Coast Card in May 2005, we ceased sales of paper assured loading tickets. A $2.0 million adjustment was made in fiscal 2006 reflecting the reassessment of the deferred revenue liability relating to historical sales of paper tickets and is included in other revenue in the above table.

Other Routes

Fiscal year ended March 31 ($000's)	2006	2005	Increase (Decrease)	
Direct Route Revenue				
Vehicle traffic (volume)	4,752,901	4,748,539	4,362	0.1%
Vehicle tariff	54,035	52,440	1,595	3.0%
Passenger traffic (volume)	10,673,745	10,804,187	(130,442)	(1.2%)
Passenger tariff	35,110	33,811	1,299	3.8%
Social program fees	6,885	6,154	731	11.9%
Catering & on-board	12,442	11,814	628	5.3%
Reservation fees	1,062	845	217	25.7%
Stateroom rental	1,024	1,040	(16)	(1.5%)
Parking	174	172	2	1.2%
Other revenue	276	205	71	34.6%
Total Direct Route Revenue	111,008	106,481	4,527	4.3%
Indirect Route Revenue				
Ferry service fees	93,549	93,558	(9)	(0.0%)
Federal-Provincial subsidy	24,890	24,343	547	2.2%
Total Route Revenue	229,447	224,382	5,065	2.3%
Retail gross margin	7,566	7,201	365	5.1%

Passenger traffic decreased marginally while vehicle traffic remained steady. The average increase in tariff per vehicle was $0.33 while the average passenger tariff increased $0.16 per passenger. The increased average fares, partially offset by the reduction in passenger traffic levels resulted in a total tariff revenue increase of $2.9 million.

Reimbursements from the Province for social program fees increased as a result of higher tariffs and higher program usage.

Retail sales increased mainly as a result of higher food sales per customer, partially offset by lower passenger traffic.

The increase in reservations fees reflects higher usage and a higher fee for booking within the week of travelling implemented in the third quarter of fiscal 2006.

Expenses

Expenses for the past three fiscal years are summarized in the table below.

Year ended March 31	2007	2006	2005
Expenses ($ millions)			
Operations	309.1	291.7	294.0
Maintenance	84.9	81.1	86.8
Administration	50.6	51.2	44.5
Total operations, maintenance & administration	444.6	424.0	425.3
% Increase (decrease)	4.9%	(0.3%)	3.5%
Cost of retail goods sold	28.3	27.0	26.5
Amortization	55.5	53.1	47.7
Total expenses	528.4	504.1	499.5
% Increase	4.8%	0.9%	3.7%
Interest and other			
(Gain) loss on foreign exchange	(0.4)	(0.2)	0.1
Interest expense	19.3	25.1	24.5
Loss on disposal of capital assets	0.2	0.3	0.6
Total interest and other	19.1	25.2	25.2

Fuel Deferral and Related Surcharge

In September 2004, the British Columbia Ferries Commissioner issued an order authorizing us to maintain deferred fuel cost accounts to mitigate the effect on our earnings of volatility in fuel oil prices.

The Commissioner established set prices for fuel oil for each of the years until March 31, 2008. At the start of each fiscal year in the first performance term, the set prices increase by the Consumer Price Index (Vancouver). The first such increase, effective April 1, 2005, was 2.0%. The Commissioner ordered an additional 5% increase in the set price per route group effective July 24, 2005. On April 1, 2006 our set prices increased a further 1.9%. On March 30, 2007, the Commissioner proposed the continued use of set prices for fuel oil for the second performance term.

Differences in fuel costs arising from our actual price paid per litre being higher or lower than the unit set price are charged or credited to the deferred fuel cost accounts.

Continuing high fuel costs have caused increases in the balances of the deferred fuel cost accounts. We filed applications with the British Columbia Ferries Commissioner under Section 42 of the *Coastal Ferry Act* requesting extraordinary price cap increases to allow for fuel surcharges in order to reduce or eliminate these balances. After receiving approval, we implemented fuel surcharges on July 25, 2005, February 1, 2006 and June 22, 2006. Proceeds from the fuel surcharges are credited against balances in the deferred fuel cost accounts.

Under an agreement reached in March 2007, the Province made a one-time $7.0 million ferry service fee payment for fiscal 2007, that was applied against the deferred fuel cost accounts in accordance with the agreement. As a result, the balances in our deferred fuel cost accounts totalled $18.8 million at March 31, 2007 ($22.7 million at March 31, 2006).

In the absence of this one-time payment, the balance of the deferred fuel cost accounts would have grown to $25.8 million.

The Commissioner has also set an efficiency target requiring us to reduce fuel consumption by 1% in fiscal 2007 and by an additional 1% in fiscal 2008. We filed our fuel savings plan with the Commissioner in June 2006. This plan is available on our website at: www.bcferries.com.

During the year ended March 31, 2007, and after removing the impact of the loss of the Queen of the North, we bettered the fuel consumption target set by the Commissioner. We have decreased our annual consumption by over six million litres (5.1%) from the level of fuel consumed three years prior. We are continuing to implement a wide variety of fuel saving measures ranging from operating our vessels more efficiently to installing new, more fuel-efficient engines on some of our vessels and fuel monitoring systems on others.

All of the Commissioner's Orders can be viewed on the Commissioner's website at www.bcferrycommission.com.

Year to Year Comparison of Expenses 2007 – 2006

The $17.4 million increase in operations expenses reflecting:

- $8.5 million increase in wages and benefits, including lump sum payments to employees totalling $3.4 million, as a result of the arbitration award; $1.2 million in additional training costs (an increase in operational training from approximately 8,000 to approximately 11,000 person days); and wage rate increases of $6.7 million, partially offset by improved labour scheduling practices and as a result of reduced service on northern routes;
- $3.8 million increase in property tax expense. In fiscal 2006 we received a refund of $8.2 million in settlement of terminal property tax assessment appeals for 2004 and 2005;
- $2.6 million increase reflecting our renewed uniform program; and
- $1.6 million net increase in marine insurance premiums.

Maintenance expenses, which include expenditures for vessel refit and maintenance as well as terminal maintenance activities, were $3.8 million higher, reflecting our commitment to safety.

Administration expenses decreased $0.6 million mainly as a result of a $2.2 million reduction in severance and restructuring costs, partially offset by a $1.5 million increase in data communications and telecommunication costs.

Amortization increased a total of $2.4 million as a result of additional assets coming into service including $1.8 million reflecting the *Queen of Surrey* $37.2 million upgrade.

Interest expenses decreased $5.8 million due to:

- $4.0 million of additional interest capitalized reflecting our investment in fleet and terminal revitalization plans;
- $2.7 million increase in interest rate support recorded under the Structured Financing Facility Program offered by the Government of Canada. A total of $9.9 million in support for the *Queen of Oak Bay, Queen of Nanaimo* and *Queen of Surrey* mid-life upgrades has been granted of which we have reflected $4.7 million ($2.0 million in fiscal 2006) as a decrease in bond interest costs and $0.5 million ($0.6 million in fiscal 2006) to offset interest costs previously capitalized on the upgrades. The remaining $2.1 million will be applied against future bond interest costs.

These decreases in interest expense were partially offset by an overall increase in our average level of debt and the effect of interest rates payable on the debt instruments issued and in place as described in the "Liquidity and Capital Resources" section below.

Year to Year Comparison of Expenses 2006 – 2005

The $2.3 million decrease in operations expenses reflects a $7.7 million net decrease in property tax expense primarily as a result of the settlement of our 2004 and 2005 terminal property assessment appeals. This reduction in property tax expense was partially offset by increases of:

- $3.6 million in wages and benefits;
- $0.7 million in the total fuel costs due to a 7% increase in the set price as approved by the British Columbia Ferries Commissioner, partially offset by efficiency savings;
- $1.3 million in marine insurance; and
- $1.2 million of costs not covered by third party insurance relating to the grounding of the *Queen of Oak Bay*. In June 2005, the *Queen of Oak Bay*, which sails between Departure Bay and Horseshoe Bay, ran aground on its approach to Horseshoe Bay terminal.

Maintenance expenses were $5.7 million lower, mainly due to the higher maintenance costs incurred in fiscal 2005 for one-time costs required to meet Transport Canada requirements.

Administration expenses increased $6.7 million, including:

- $3.7 million for corporate information technology support for our many new initiatives and upgrades to our computer systems;
- $2.1 million resulting from our internal control certification project to document and test the effectiveness of internal controls on which management is relying to support certifications required by the Canadian Securities Administrators; and
- $2.1 million costs for severance and restructuring.

These increases were partially offset by administrative efficiencies.

Amortization increased a total of $5.4 million as a result of additional assets coming into service including:

- $1.7 million reflecting the *Queen of Oak Bay* $35.1 million upgrade;
- $1.7 million reflecting new information technology including our Coast Card, our new point of sale system, crew scheduling system and enterprise resource planning projects.

Interest expenses increased $0.6 million reflecting the overall increase in our average level of debt and the effect of interest rates payable on the debt instruments issued and in place. Increases in debt costs were partially offset by interest rate support totalling $2.0 million recorded under the Structured Financing Facility Program for the *Queen of Oak Bay* and *Queen of Nanaimo* mid-life upgrades.

Liquidity and Capital Resources

We fund our operations and capital acquisitions with cash flow generated from operations, as well as bank financing and debt issues. We expect operating cash flows to fund approximately one half of the capital expenditures over the next five years, with the balance funded by borrowings.

Long-Term Debt

In May 2004, we entered into a master trust indenture. This indenture established common security and a set of common covenants by us for the benefit of our lenders. Our financing plan encompasses an ongoing program capable of accommodating a variety of corporate debt instruments and borrowings ranking *pari passu*. We do not currently view common share equity as a potential source of capital and have no present intention of offering common shares to the public or other investors.

Under this indenture we completed two $250 million public offerings in fiscal 2005: a 5.74% Senior Secured Bonds, Series 04-1, due May 27, 2014 and a 6.25% Senior Secured Bonds, Series 04-4, due October 13, 2034. The net proceeds were used primarily to repay a portion of our indebtedness to the Province, to fund reserves required in connection with these bonds and for general corporate purposes. Interest on these bonds is payable semi-annually.

We also entered into a credit agreement with a syndicate of Canadian banks which is secured under the indenture. Under this agreement, we have available a five year revolving facility in the amount of $155 million which expires May 12, 2012, but is renewable annually under certain conditions. This replaced a one-year and a three-year revolving credit facility of $77.5 million each that we held at March 31, 2006. The revolving term facility is available for working capital purposes, to fund the upgrade and acquisition of vessels and terminal upgrades and other general corporate purposes.

In fiscal 2006, we finalized two loan agreements with KfW, a German export credit bank. These agreements are secured under the Master Trust Indenture. The agreements allow us to borrow up to $90 million per loan, with the net proceeds to be used to finance the purchase of two of the three Super C-class vessels currently being built. These funds will not be advanced until the date upon which we accept delivery of the applicable vessel from the ship builder. The principal amount of each loan will be repaid over the twelve year term of the loan.

In March 2007, we closed a $250 million senior secured bond issue, Series 07-1, due March 20, 2037. These private placement bonds will bear interest at 5.021%, payable semi-annually. The net proceeds will be used primarily to repay our credit facility, to fund capital expenditures and for general corporate purposes.

Terminal Leases

We entered into a master agreement with the British Columbia Transportation Financing Authority ("BCTFA") effective March 31, 2003, as part of the restructuring of our Company. In return for the transfer of ownership interest in all ferry terminals from the former British Columbia Ferry Corporation to the BCTFA at the time of the corporate restructuring, we received recognition of prepayment of rent under terminal leases. The leases grant us exclusive access and use of ferry terminal properties for a period of 60 years commencing April 1, 2003. The leases are renewable for an additional period of 20 years at a total cost of $20 per lease if the Coastal Ferry Services Contract is renewed. We must manage, maintain and develop the terminals at our own cost.

Since the original transfer, $5.1 million of additional lands at Horseshoe Bay and Swartz Bay were added to the existing terminal leases in exchange for highway improvements.

If we fail to meet our obligations under the terminal leases or default under the Coastal Ferry Services Contract, the BCTFA may at its option re-enter and take possession of the ferry terminal properties and at its option terminate the leases. The BCTFA has entered into an acknowledgement agreement with the Bondholders' Trustee which sets out certain limitations of the use of this option.

In addition to the above, we have entered into a 40-year lease agreement with the Town of Sidney, BC to manage and develop an existing ferry terminal owned by the town. This terminal is the western end of a ferry route connecting Vancouver Island with Anacortes, WA. The route is operated by Washington State Ferries.

Other Long-Term Liabilities

Other long-term liabilities consist primarily of accrued post-retirement and post-employment benefits.

Sources & Uses of Cash

Our liquidity needs are met through a variety of sources, including cash generated from operations and borrowings under our credit facility. Our primary uses of funds are operational expenses, capital asset acquisitions and upgrades and interest payments on our long-term debt.

Sources and uses of cash and cash equivalents for fiscal years 2007 and 2006 are summarized in the table below.

Year ended March 31 ($ millions)	2007	2006
Net income before extraordinary gain	48.8	49.9
Extraordinary gain	61.3	-
Items not involving cash:		
Amortization	55.5	53.1
Other non-cash charges	(1.9)	1.1
Regulatory costs deferred	3.9	(14.8)
Change in operating working capital	(7.1)	9.5
Cash provided by operating activities	160.5	98.8
Cash provided (used) by financing activities	266.7	(6.7)
Cash used in investing activities	(249.4)	(131.3)
Total increase (decrease) in cash	177.8	(39.2)

In fiscal 2007, cash provided by operating activities includes a decrease in regulatory costs deferred of $3.9 million. This reduction is a result of $3.1 million net increase in deferred fuel costs being more than offset by the $7.0 million ferry service fee payment which was applied to the deferred fuel cost accounts.

Cash provided by operating activities also includes an increase in non-cash working capital of $7.1 million. This increase was primarily due to:

- $6.1 million decrease in GST payable reflecting an April 2006 payment of denied ITC claims. Effective April 2, 2003, we became subject to GST but are limited in our ability to obtain input tax credits ("ITCs") because certain of our services are exempt under the Excise Tax Act. In fiscal 2006, we reviewed the options available to us and filed an amended ITC claim for the period April 2, 2003 through June 30, 2005. Canada Revenue Agency ("CRA") has completed an audit of our GST filings, including review of our amended claims. Although CRA determined the methods used in our revised filings to be generally fair and reasonable, they have denied us the ability to file the amended claim which totalled $3.2 million. In addition, CRA has taken the position that vessel fuel and lubricants used for propulsion supports only GST exempt lines of business resulting in denial of ITC claims of approximately $2.2 million for the period April 2, 2003 through March 31, 2006. In April 2006, we paid all amounts related to the denied ITC claims. However, we disagree with CRA's interpretation of the law in this instance and are pursuing recovery through the appeal process;
- $5.7 million decrease in payables and accrued liabilities relating to refit and maintenance and other operating activities; and
- $2.0 million decrease in deferred revenue resulting from a $3.1 million writedown of liability relating to historical sales of paper assured loading tickets, partially offset by an increase due to fiscal 2007 ticket sales.

The working capital increase was partially offset by:

- $2.6 million increase in accrued employee liabilities, mainly related to time banks;
- $2.2 million net decrease in accounts receivable consisting of receipt of $6.6 million insurance proceeds resulting from the loss of the *Queen of the North* and $5.5 million in property tax refunds, partially offset by increases of:
  - $6.2 million ferry service fee receivable;
  - $1.1 million GST receivable;
  - $1.0 million interest rate support receivable;
  - $0.9 million insurance claims receivable;
- $1.4 million decrease in inventory due to inventory level adjustments and strategic sourcing initiatives; and
- $0.5 million net change in other current assets and liabilities.

Cash provided from financing activities reflects our new $250 million, Series 07-1 bond issue described above and the net change in short-term financing.

Cash used in investing activities was primarily due to capital expenditures. The significant capital transactions during fiscal 2007 are described below in "Investing in Our Capital Assets".

Investing in our Capital Assets

Capital expenditures in fiscal 2007 totalled $262.6 million. This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures included:

- $206.0 million in new vessels, vessel upgrades and modifications including:
  - $99.1 million of a total budget of $102 million for the purchase and modification of the *Northern Adventure*;
  - $25.4 million of the $38 million mid-life upgrade which includes safety, structural and mechanical improvements to the *Queen of Alberni*;
  - $21.5 million of the $542 million Super C-class new vessel construction project;
  - $13.0 million of the $57 million project for the construction of a new intermediate class vessel to replace the *Queen of Tsawwassen*;
  - $10.9 million of the completed $37 million mid-life upgrade which included safety, structural and mechanical improvements to the *Queen of Surrey*;
  - $9.2 million of the $12 million completed reconstruction of the *Kuper*;
  - $8.7 million of the budgeted total of $24 million for the upgrade and replacement of propulsion and safety equipment on the *Quinsam*, the *Quinitsa* and the *Queen of Capilano*;
  - $7.4 million of the $200 million project for the construction of the new *Northern Expedition*;
- $38.0 million in marine structures at many of our terminals, including:
  - $11.4 million of a $16 million project to upgrade the berths at Departure Bay terminal;
  - $7.0 million of a $12 million project to upgrade the berths at Horseshoe Bay terminal;
  - $6.2 million of a $24 million completed project to construct a new berth at Swartz Bay terminal; and
  - $3.7 million of the completed terminal modifications to accommodate the new *Northern Adventure*;
- $11.6 million in terminal and building upgrades and equipment, including $5.2 million at Swartz Bay, $1.8 million at Departure Bay and $1.2 million at Alert Bay terminals. Over the next five years, we plan to invest $237 million in our terminals for building and marine structure upgrades; and
- $6.9 million in computer hardware and software development which will improve communications technology and enhance customer service in areas such as automated ticketing, retail and food service management and security of customer credit card information.

Major Vessel Upgrades

The *Queen of Surrey*, which provides service on our Langdale-Horseshoe Bay route, returned to service on June 27, 2006, following an extensive $37 million mid-life upgrade. The 26-year-old vessel underwent significant upgrades to prepare it for another 20 years of service. The upgrades included safety, structural and mechanical improvements as well as improved and expanded passenger amenities. The *Queen of Surrey* is the fourth of five C-class vessels identified for mid-life upgrade. Similar upgrades have already been undertaken on the *Queen of Coquitlam*, *Queen of Cowichan* and *Queen of Oak Bay*.

The fifth, and final, C-class vessel to undergo such a major upgrade, the *Queen of Alberni*, began its upgrade in November 2006. The vessel, which usually provides service on our Duke Point – Tsawwassen route, commenced its six-month $38 million mid-life upgrade at Vancouver Drydock in North Vancouver. The vessel's extensive upgrade will include safety and mechanical improvements, as well as new passenger amenities and will prepare the 31-year-old vessel for another 20 years of service.

Coastal Renaissance, Coastal Inspiration and Coastal Celebration

In September 2004, we entered into contracts with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany to build three new Super C-class vessels that will be the largest double ended vessels in the world. Each vessel will measure 160-metres in length and have a capacity of 1,650 passengers and 370 vehicles. The contracts are design-build and fixed price, totalling $325 million. They provide us with substantial guarantees related to delivery dates, performance criteria, cost certainty and quality of construction. These contracts, together with the related import duty and taxes of approximately $112 million, form the majority of the total project budget of $542 million. We are currently seeking a remission of the import duty, but we are uncertain as to the outcome of this application. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk.

Construction of the *Coastal Renaissance* started in August 2006, and the vessel was launched in Germany in April 2007. Construction of the *Coastal Inspiration* commenced in November 2006 while construction of the *Coastal Celebration* began in April 2007. These new vessels will replace aging vessels which currently provide service on our major routes. The *Coastal Renaissance* is expected to be in service in early 2008. Delivery of the other two Super C-class vessels is expected in early and mid 2008, respectively. This project is expected to be completed on schedule and within budget.

Northern Adventure

In March 2007, the *Northern Adventure* went into service on our northern routes, in time to relieve the *Queen of Prince Rupert* for its annual refit. The two-year-old vessel, a replacement for the *Queen of the North*, was purchased for $51 million in October 2006.

The import duty and taxes on this vessel purchase totalled $17 million. We are currently seeking a remission of the import duty portion of this payment, but we are uncertain as to the outcome of this application. The vessel underwent significant modifications at Victoria Shipyards to update safety and security equipment, modify the stern, upgrade electrical, heating and lighting systems and upgrade customer amenities. This 117-metre vessel has 74 state rooms and will accommodate over 600 passengers and 101 vehicles. The *Northern Adventure* underwent further modifications during May 2007, prior to the start of the busy summer season. The total budget for the acquisition and modification of this vessel is $102 million.

Northern Expedition

Following a rigorous competitive bidding process, we signed a $133 million contract with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany to build a new vessel to replace the 41-year-old *Queen of Prince Rupert*, operating on our northern routes. The import duty and taxes on this contract will total approximately $43 million. We will be seeking a remission of the import duty, but we are uncertain as to the outcome of our future application. This design-build, fixed price contract (the majority of the total project budget of $200 million) provides us with substantial guarantees for delivery dates, performance criteria, cost certainty and quality of construction. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 55 staterooms and will accommodate 130 vehicles and 600 passengers.

New Intermediate Vessel

In December 2006, the keel was laid for a new intermediate class ferry at Vancouver Shipyards in North Vancouver. The $45.5 million contract with Vancouver Shipyards constitutes the majority of the total project budget of $57 million. The new intermediate vessel will allow for the retirement of the 47-year-old *Queen of Tsawwassen*. Once complete, the vessel will measure 100-metres in length and have a capacity of 600 passengers and 125 vehicles. It will feature a new state-of-the-art lifesaving system as well as a variety of amenities including a comfortable lounge and snack bar for passengers to enjoy. The vessel is expected to be in service by the summer of 2008.

Kuper

In March 2007, a new addition to our fleet, the *Kuper*, went into service on our smaller island routes. The hull of the new vessel is built from the original structure of the *John Atlantic Burr*, which we purchased in August 2005 from the State of Utah Transportation Department. The vessel was disassembled in Utah and rebuilt with significant upgrades at Allied Shipbuilders in North Vancouver. During the construction period, a new 11-foot wide longitudinal section was inserted into the hull to provide an additional lane on the vehicle deck. The project also included new lifesaving equipment, navigational equipment, piping and electrical system. The total cost of this 32-vehicle ferry was $12 million. The Kuper is the fourth and largest of our "K-class" vessels, joining the *Kahloke*, the *Klitsa* and the *Kwuna*.

Terminal Marine Structures

As we reinvest in our terminal infrastructure and prepare for the arrival of the new Super C-class vessels, significant upgrades are underway at many of our terminals.In October 2006 we officially opened a new state-of-the-art berth at Swartz Bay terminal on Vancouver Island. This $24 million project was undertaken to replace the outdated counter-weighted ramp lift system and certain old marine structures and brings a new level of technology to our berthing arrangements for our largest vessels. The improved design of this new floating berth will speed up the loading and unloading process with fewer ramp adjustments as the ramp rises and falls with the tide. This berth is now able to accommodate our Spirit-class vessels and will also be able to service the new Super C-class vessels.

Modifications of marine structures are currently underway at Departure Bay and Horseshoe Bay terminals to accommodate the new Super-C vessels. These berth upgrades, expected to be complete in the fall of 2007, include new trestles, dolphins[2] and catwalks.

Modifications were completed in March 2007 at Prince Rupert, Port Hardy, McLoughlin Bay and Skidegate terminals to accommodate the new *Northern Adventure*. The *Northern Adventure* is wider at the stern than our other northern service vessels. To enable stern loading and unloading, modifications to the terminal marine structures were necessary for access to berths for safe docking.

Information Technology

In September 2006, we implemented an automated ticketing pilot project at our Tsawwassen and Swartz Bay terminals on our major routes. Foot passengers at these terminals now have the option of using the automated ticketing kiosks or a staffed ticket booth to purchase tickets. Passengers have the option to pay with either a debit or credit card at the kiosks. This project has been well received by our customers. In fiscal 2007 we incurred $0.5 million of the $1.3 million total project costs. We expect to proceed with implementing this technology at other locations in the near future.

We have also completed $3.0 million ($1.8 million in fiscal 2007) of a $4.5 million project to improve communication technology services, replace obsolete technology, reduce costs and manage growth as our business demands change. This project is expected to improve ship-to-shore data communications and provide a more stable, secure and faster network.

Other ongoing projects include a new time collection system, enhanced reporting initiatives, enhanced crew scheduling system, and security projects. These projects focus on obtaining efficiencies, improving safety and security and providing better service to our customers.

[2] A cluster of pilings firmly fixed to the sea bed and used to assist vessels during docking

Management's Discussion & Analysis

FOURTH QUARTER RESULTS

This section provides an overview of our financial performance for the three months ended March 31, 2007 compared to the three months ended March 31, 2006.

The fourth quarter reflects a seasonal reduction in traffic levels which we utilize to perform upgrades and major maintenance and refit programs as well as to undertake mandatory inspections on the majority of our vessels.

Three Months Ended March 31 ($ millions)	**2007**	2006	Variance	
Total revenue	119.0	109.7	**$** 9.3	**%** 8.5%
Expenses	146.7	128.4	(18.3)	(14.3%)
Loss from operations	(27.7)	(18.7)	(9.0)	(48.1%)
Interest and other	5.5	6.1	0.6	9.8%
Net loss	(33.2)	(24.8)	(8.4)	(33.9%)

Revenue

Our total revenues have increased as shown in the following table.

Year ended March 31 ($ millions)	**2007**	2006	Increase (Decrease)	
Direct Route Revenue				
Vehicle traffic (volume)	1,707,063	1,714,872	**$** (7,809)	**%** (0.5%)
Vehicle tariff	43.7	39.3	4.4	11.2%
Passenger traffic (volume)	4,034,986	4,060,218	(25,232)	(0.6%)
Passenger tariff	23.7	21.5	2.2	10.2%
Social program fees	3.7	3.0	0.7	23.3%
Catering & on-board	13.0	11.9	1.1	9.2%
Other revenue	6.3	5.1	1.2	23.5%
Total Direct Route Revenue	90.4	80.8	9.6	11.9%
Indirect Route Revenue				
Ferry services fees	20.2	21.1	(0.9)	(4.3%)
Federal-Provincial subsidy	6.3	6.2	0.1	1.6%
Total Route Revenue	116.9	108.1	8.8	8.1%
Other general revenue	2.1	1.6	0.5	31.3%
Total Revenue	119.0	109.7	9.3	8.5%

Higher average tariff rates and higher traffic volume on our major routes are partly offset by lower traffic volume on our other routes.

Ferry service fees have been reduced to reflect a negotiated agreement to repay the Province $0.9 million in ferry service fees regarding the modified summer service we provided on our northern routes as a result of the loss of the *Queen of the North*.

Other direct revenue has increased due to the inclusion of a $3.1 million ($2.0 million in fiscal 2006) write down of the deferred revenue liability relating to historical sales of paper assured loading tickets ("ALTs"). Sales of paper ALTs ceased in May, 2005 upon introduction of the Coast Card.

Expenses

Expenses are shown in the following table.

Three months ended March 31 ($ millions)	**2007**	2006	(Increase) Decrease	
Operations	77.6	62.4	**$** (15.2)	**%** (24.4%)
Maintenance	31.8	28.1	(3.7)	(13.2%)
Administration	16.7	18.7	2.0	10.7%
Cost of retail goods sold	5.4	5.0	(0.4)	(8.0%)
Amortization	15.2	14.2	(1.0)	(7.0%)
	146.7	128.4	(18.3)	(14.3%)
Interest & other	5.5	6.1	0.6	9.8%
Total expense	152.2	134.5	(17.7)	(13.2%)

The increase in operations reflects an $8.0 million increase in property tax expense. In fiscal 2006, we received a refund of $8.2 million in settlement of terminal property assessment appeals for fiscal years 2004 and 2005. Other increases include wages and benefits for lump sum payments to employees totalling $3.4 million, as a result of the arbitration award and additional training costs.

Maintenance costs reflect increased maintenance requirements of our fleet and terminals and a decision to bring forward vessel refit and maintenance activities originally planned for fiscal 2008.

Lower administration costs reflect the additional costs of restructuring and additional pension costs due to past service purchases experienced in fiscal 2006.

Amortization increases reflect the vessel, terminal and other projects that came into service during fiscal 2007.

Management's Discussion & Analysis

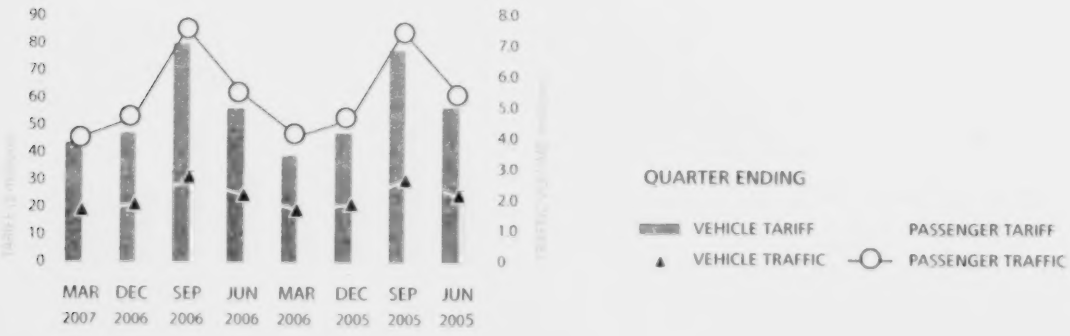
SUMMARY OF QUARTERLY RESULTS

The table below compares earnings by quarter for the most recent eight quarters.

Quarter Ended (unaudited) ($ millions)	Mar 07	Dec 06	Sep 06	Jun 06	Mar 06	Dec 05	Sep 05	Jun 05
Total revenue	119.0	128.4	202.7	146.2	109.7	126.0	198.3	145.2
(Loss) earnings from operations	(27.7)	2.5	73.0	20.2	(18.7)	5.4	67.3	21.1
Net (loss) earnings before extraordinary gain	(33.2)	(1.8)	68.9	14.9	(24.8)	(0.9)	61.2	14.4
Extraordinary gain	0.0	0.0	0.0	61.3	0.0	0.0	0.0	0.0
Net (loss) earnings	(33.2)	(1.8)	68.9	76.2	(24.8)	(0.9)	61.2	14.4
Maintenance expense	31.8	21.9	13.4	17.9	28.1	21.8	13.1	18.1
Maintenance as % of total operating expense	22%	17%	10%	14%	22%	18%	10%	15%

Quarterly results are affected by the seasonality of leisure travel patterns. The second quarter, covering the summer period, experiences the highest traffic levels and the highest net earnings. The third and fourth quarters reflect a seasonal downturn in traffic. We utilize these periods to perform upgrades and major maintenance and refit programs as well as to undertake mandatory inspections on the majority of our vessels.

The following graph demonstrates the seasonality of our revenue and shows the relationship of traffic volume and tariff revenue over the most recent eight quarters.



OUTLOOK

Safety

The safety of the public, our employees and the protection of the environment are our highest priorities. In July 2006, we commissioned former BC Auditor General, George L. Morfitt to conduct an independent review of our safety policies, procedures and practices. The report resulting from this comprehensive safety review was received in January 2007. The report, which makes 41 recommendations on safety enhancements, states the following conclusion in its summary overview:

"We concluded from our review that, overall, the company is operating a safe coastal ferry transportation system. The company directors, management and staff are highly committed to operational safety, both for the travelling public and for BC Ferries personnel. Nevertheless, there are a number of areas identified in this report where safety and related administrative processes and procedures should be strengthened."

We are implementing all of the various recommendations in the report. Some recommendations have already been put into practice and some will be incorporated into our new safety program. During fiscal 2008 we plan to increase the level of operational training we conduct from approximately 11,000 to approximately 14,000 person days. This increase in training, together with other planned safety initiatives, will increase our safety related expenditures by over $4 million next year. We also plan to conduct a similar comprehensive operational safety review at a minimum of every five years as part of our ongoing commitment to ensuring the safety of our passengers and employees.

A copy of the report is available on our website at: **http://www.bcferries.com/news/files/07-008morfitt_safety_review.pdf**

Traffic

Ferry traffic levels are affected by a number of factors including transportation costs, the value of the Canadian dollar, weather, global security, levels of tourism, disposable personal income, the local economy and population growth. We experienced a moderate decrease in both total passenger and total vehicle traffic in the last two fiscal years, however over the past five years they are both trending upwards.

During the last two fiscal years, some events that negatively affected traffic levels were the implementation of three fuel surcharges, the loss of capacity on our Northern routes and an unprecedented number of severe wind and snow storms in November and December, 2006. With the introduction of the new *Northern Adventure* into service in March 2007, we anticipate traffic on our northern routes to return to former levels. Over the next few years, we anticipate modest traffic volume increases on all our routes.

Vehicle Traffic by fiscal year (thousands)	**2007**	2006	2005	2004	2003
Major routes	3,826.5	3,790.4	3,808.8	3,688.1	3,734.4
Other routes	4,695.4	4,752.9	4,748.6	4,604.1	4,587.1
Total	8,521.9	8,543.3	8,557.4	8,292.2	8,321.5
Annual % increase (decrease)	(0.3%)	(0.2%)	3.2%	(0.4%)	2.7%
Five year % increase	2.4%				

Passenger Traffic by fiscal year (thousands)	**2007**	2006	2005	2004	2003
Major routes	11,146.3	11,055.9	11,222.4	10,824.7	11,104.2
Other routes	10,518.7	10,673.7	10,804.1	10,542.7	10,520.0
Total	21,665.0	21,729.6	22,026.5	21,367.4	21,624.2
Annual % increase (decrease)	(0.3%)	(1.3%)	3.1%	(1.2%)	1.8%
Five year % increase	0.2%				

Market Growth

Notwithstanding the pressure on traffic volumes, we see opportunities for growth. Container traffic to Vancouver Island is expected to expand as overseas container movements to the Vancouver Gateway increase and large "big box" retailers continue to locate on Vancouver Island.

We have experienced a steady growth in ancillary revenues. We see continuing opportunities to improve the revenue from our ancillary services including reservations, food and retail and assured loading.

In February 2007, we signed a 40 year lease with the Town of Sidney on Vancouver Island under which we will manage and develop the town's international ferry terminal. The lease recognizes Washington State Ferries as a priority user and promotes use by other operators. This provides us with an opportunity to support the community and to develop innovative new business strategies.

Asset Renewal Program

Although we have one of the largest fleets in the world, the average age of our assets is currently among the oldest of major ferry operators worldwide. To address this we will continue with our fleet and asset renewal program. We added two new vessels to our fleet this fiscal year, the *Northern Adventure* and the *Kuper*. Over the five year period ending March 2012, we expect to spend approximately $1.2 billion, which includes bringing six new vessels into service. Upgrading and replacing a large share of our fleet through new vessel acquisitions and our revitalization program will assist in maintaining operational reliability. We continue to reinvest our retained earnings into our asset renewal program. As the capital projects are completed and come into service, amortization and financing costs will increase. We expect that this will cause a decrease in our future earnings in the near term.

Regulation

Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. It is expected that a revised Act with more stringent regulations will be introduced in the near future. At present, the impact of the revised regulations on the useful life of some of our vessels and/or the requirement for vessel upgrades is not well defined. We will address this changing regulatory environment through our planning processes and asset renewal initiatives as information becomes available. As always, the safety and security of our customers and employees remains our highest priority.

In 2001, the federal government enacted the *Marine Transportation Security Act*. Initially the legislation and the associated regulations were limited to international ports and vessels. These regulations have been extended to include domestic marine services, including domestic ferries. We will be required to satisfy a specific level of security on our vessels and at our terminals servicing our major routes by November 2009. Considerable security investments will be required in the areas of fencing, cameras, closed circuit TV, better access controls and screening. We are in the process of defining the capital and operating requirements necessary for us to comply with the upcoming regulations. Through the Marine Security Contribution Program, we are eligible for reimbursement of $3.8 million of federal funding to help offset the costs of perimeter security, access control measures and training.

Our tariffs are regulated and our service levels are monitored by the British Columbia Ferries Commissioner. The Commissioner regulates our tariffs by establishing price caps over a performance term. Our first performance term ends March 31, 2008 and our second performance term ends March 31, 2012. In March 2007, the Commissioner set preliminary price caps for the second performance term.

Competition

New competitors have emerged in both the passenger only market as well as the commercial traffic market in the past few years. To date, passenger only competitors have not been successful at sustaining operations. Competition may increase in these markets with the potential emergence of alternate vehicle and passenger ferry services. We remain mindful of these potential changes in the market, and we are constantly seeking ways to improve operational efficiency and customer service.

We are also exploring opportunities with additional or alternative service providers, in an effort to reduce costs and provide services on our regulated routes, as mandated by the *Coastal Ferry Act*. While we maintain responsibility for the long-term delivery of ferry services, we are required to test the market to determine if another operator, under contract to us, can provide a more cost-effective service offering. In February 2007, we issued a Request for Proposal on the Brentwood Bay-Mill Bay route to two proponents. The closing date is June 15, 2007 and we expect to make a decision whether to proceed with an alternative service provided on this route by the end of December 2007. We are also currently working with a potential alternate service provider regarding a possible pilot project for the Buckley Bay to Denman Island and Hornby Island to Denman Island routes. Additionally, we expect to issue a Request for Proposals regarding the operation of our four routes north of Port Hardy however, the timing of this request is uncertain.

FINANCIAL INSTRUMENTS

Fair market value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgment.

Derivatives

We hedge our exposure to fluctuations in fuel prices and foreign currency exchange rates through the use of derivative instruments. The table below indicates the change in valuation of the derivative instruments for the year ended March 31, 2007.

	March 31, 2007				March 31, 2006	
($ millions)	Number of swaps	Term to maturity (years)	Carrying Value Asset (Liability) ($millions)	Fair Value ($millions)	Carrying Value Asset (Liability) ($millions)	Fair Value ($millions)
Commodity Fixed Price Swaps	3	Up to .5	0.7	0.7	0.9	0.9
Foreign Exchange Forward Transactions (Super C-class vessels)	23	Up to 1.5	0.0	(18.7)	0.0	(45.3)
Foreign Exchange Forward Transactions (Northern Adventure)	6	Up to 2.0	(2.8)	8.6	0.0	0.0

The commodity derivatives fair value reflects only the value of the commodity derivatives and not the offsetting change in value of the underlying future purchase of fuel. These fair values reflect the estimated amounts that we would receive or pay should the derivative contracts be terminated at the stated dates. Any gains or losses related to fuel commodity swaps are charged to our deferred fuel cost accounts. At March 31, 2007 we have recorded a receivable of $0.7 million as the estimated gain to terminate the contracts as at this date.

The foreign exchange derivative fair value reflects only the value of the foreign exchange derivatives and not the offsetting change in value of the underlying future purchase of currency. These fair values reflect the estimated amounts we would receive or pay to terminate the derivative contracts at the stated dates. The derivatives relating to the Super C-class vessels contract are accounted for using hedge accounting and therefore estimated gains and losses are not recorded in our financial statements. The derivatives relating to the Northern Expedition were entered into in August 2006. These are accounted for using hedge accounting commencing October 16, 2006 when appropriate documentation was completed. Any gains or losses related to these foreign exchange forward contracts are charged to our regulatory asset accounts. At March 31, 2007 we have recorded a payable of $2.8 million as the estimated market value of the loss to terminate the contracts as at October 16, 2006, after which time hedge accounting was applied.

We are exposed to credit risk in the event of non-performance by counterparties to derivative instruments. Because we deal with high credit quality institutions in accordance with established credit approval practices, we believe it to be unlikely that any counterparties will fail to meet their obligations.

RISK MANAGEMENT

Understanding and managing risk are important parts of our business. We have processes in place throughout our company to manage risks that inevitably arise in the normal course of business.

We are working towards the completion of an Enterprise Risk Management program which will address risk management from an organization-wide perspective and will complement existing strengths. This is a comprehensive approach that incorporates organization-wide awareness, prioritized risk identification and risk mitigation strategies that target the highest risk areas. Our immediate emphasis is on implementing the recommendations included in the Morfitt operational safety review performed this fiscal year (see "Safety" below).

The following are some of the risk factors that we have considered during the risk identification process.

Accident/Casualty Loss

The occurrence of a vessel related accident or mishap could have a material adverse effect on our business prospects, financial condition or results of operations, and could result in a default under the Coastal Ferry Services Contract unless such accident or mishap qualified as an event of force majeure.

Due to the nature of our business, we may be subject to liability claims arising out of accidents or disasters, including claims for serious personal injury or death.

Apart from well established safety programs, we have a sound conventional insurance program to insure both our physical assets and legal liability for injuries and damage. This is designed to mitigate the financial impact of serious incidents. There can be no guarantee, however, that the insurance coverage will be sufficient to cover all such accidents or disasters.

In addition to conventional insurance, we have our own wholly owned insurance subsidiary, BCF Captive Insurance Company Ltd. Its prime purpose is to absorb a large proportion of the deductibles payable under our commercial insurance programs. The objective is to optimize conventional insurance programs, spread the cost of random events among all routes and protect direct route financial results from unnecessary volatility.

Asset Risk

We operate in a capital-intensive industry and have an aging infrastructure that requires substantial investment. We plan to spend approximately $1.2 billion in capital expenditures over the next five years, with approximately 75% related to new vessel acquisitions, vessel upgrades and component replacement. Our plan includes the replacement of six of our oldest vessels before the end of fiscal 2012.

At March 31, 2007, we have total long-term debt of $750 million. Future indebtedness is subject to certain limitations. The level of indebtedness could increase our vulnerability to general adverse economic and industry conditions, and limit our flexibility in planning for, or reacting to, changes in business. Also, there can be no guarantee that we will have access to sufficient resources or will be able to maintain our fleet by extending the economic life of existing vessels through major refurbishment.

Regulatory Risk

Our operations are subject to a wide variety of national and local laws and regulations, all of which may change at any time. There is the potential that the introduction of new safety or other regulations, including new taxes, or the interpretation of existing regulations, may impose a new, unexpected and significant cost burden. There can be no guarantee that regulatory changes in the future will not have an adverse effect on us.

We cannot predict how the British Columbia Ferries Commissioner's interpretation, administration and enforcement of the *Coastal Ferry Act* will change over time. Such changes may impact our ability to sustain or increase profitability.

Traffic Level and Tariff Revenue Risk

Future vehicle and passenger traffic on our vessels will be affected by, among other things, population levels and economic conditions in British Columbia and also by tariff rates. No assurance can be given as to the level of traffic on our system and the tariff revenue that will result.

There is a risk that over the long term a general decline in travel (or a reduction in the growth rate) may occur as a result of compounding increases in tariffs. Under the *Coastal Ferry Act*, we are permitted to increase tariffs on major routes by 2.8% and on the remaining routes by 4.4% each year during the first performance term. In addition to these permitted annual increases, we have applied and may again apply to the Commissioner for other tariff increases, the need for which results from extraordinary situations. In fiscal 2006 and 2007, the British Columbia Ferries Commissioner approved three extraordinary price cap increases to allow for the implementation of fuel surcharges.

To date, the price increases we have implemented have not caused an obvious decrease in demand. Significant increases in fares may occur during the second performance term. Demand elasticity could change as prices increase, thereby resulting in a negative impact on tariff revenue.

We believe that a significant number of our customers travel for leisure purposes. Traffic on our vessels may decline, or fail to increase as expected, if world or local events have a negative effect on tourism or other leisure travel.

Environmental Risk

Our operations are subject to various environmental laws and regulations dealing with the transportation, storage, presence, use, disposal and handling of hazardous materials and hazardous wastes, discharge of storm water and vessel fuel delivery.

If we were to be involved in an environmental accident or be found in material violation of applicable law and regulations, we could be responsible for material clean-up costs, property damage, and fines or other penalties, any of which could have a material adverse effect. Although we believe we maintain adequate environmental insurance, there can be no guarantee that the insurance coverage will be sufficient to cover all such losses.

Security Risk

Deliberate, malicious acts could cause death, injury or property damage. The occurrence of a major incident could also negatively affect the propensity for the public to travel, reducing our ferry traffic levels. The effect could vary depending on whether it was a domestic or international incident and whether or not it was in the marine transportation industry. It could also lead to a substantial increase in insurance and security costs. Any resulting reduction in tariff revenues and/or increases in costs could have a material adverse impact on our business, results from operations and financial condition.

Human Resources

The majority of our employees are members of the BC Ferry and Marine Workers' Union. On March 8, 2007, a final award was released by arbitrator Vince Ready, building on the October 2004 interim award. This is expected to provide us with labour stability until the end of the term on October 31, 2012 and provide a unique and innovative dispute resolution process to facilitate future collective bargaining. However, there can be no guarantee that other labour disturbances will not occur and have a material adverse effect on our operations.

We are also dependent on maintaining our ability to attract, train and retain employees with the requisite skill and capabilities to operate in the marine industry. Shortages of critical skills are emerging in some areas in which we operate.

Income Tax Risk

We received an advance income tax ruling from Canada Revenue Agency ("CRA") that, provided the facts and other statements set out therein are accurate, we are a "Tax Exempt Corporation" described in paragraph 149(1)(d.1) of the *Income Tax Act*. This ruling is subject to a proposed amendment to subsection 149(1.3) of the Income Tax Act announced by the Department of Finance on December 20, 2002, the essential elements of which are now included in a February 27, 2004 release from the Department of Finance of draft amendments to the *Income Tax Act*. We have received a non-binding opinion from CRA that proposes subsection 149(1.3), if amended as proposed on December 20, 2002, will not cause us to cease to be a Tax Exempt Corporation. There can be no assurance that subsection 149(1.3) of the *Income Tax Act* will be amended as proposed, or that we are and will continue to be a Tax Exempt Corporation.

Performance Risk

There is a risk that we will default under the Coastal Ferry Services Contract or the Terminal Leases. The consequences of such default could include, among other things, an adjustment to service fees from the Province or the forced sale of our vessels to the Province for net book value and termination of the Terminal Leases.

Treaty Negotiations: Aboriginal Rights and Title

Canadian courts have recognized that aboriginal peoples may possess rights at law in respect of land used or occupied by their ancestors where treaties have not been concluded to deal with these rights and where treaties between aboriginal peoples and the Crown set out express rights. These rights may vary from limited rights of use for traditional purposes to a right of aboriginal title and will depend upon, among other things, the nature and extent of the prior aboriginal use and occupation of lands. The courts have encouraged the Canadian federal and provincial governments and aboriginal peoples to resolve rights claims through the negotiation of treaties.

Aboriginal groups have claimed substantial portions of land in British Columbia over which they assert aboriginal title or in which they have a traditional interest.

A process is now in place within British Columbia to deal with aboriginal land claims under the British Columbia treaty process. These negotiations have been and will likely remain ongoing for a number of years, depending on the commitment of the parties involved and the precedents set by the outcomes of the first settlement agreements. Under evolving jurisprudence, Canadian governments have a duty to consult and accommodate aboriginal peoples where Crown approvals or licences are required in respect of existing or new terminal facilities or operations at such facilities and could affect or impact aboriginal interests.

Under the master agreement, the Province retains its liability, to the extent any exists, for the acts and omissions of the Province that occurred prior to our possession of the ferry terminal properties leased under the Terminal Leases and will reimburse us for any damages we suffer as a result.

In addition, the Province will reimburse us for damages suffered if there is a final court decision or a treaty settlement that recognizes or confers upon aboriginal peoples a proprietary or other interest in the ferry terminal properties which right or interest interferes with our quiet enjoyment of the ferry terminal properties as set out in the Terminal Leases.

ACCOUNTING PRACTICES

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with Canadian generally accepted accounting principles.

Our significant accounting policies are contained in note 1 to our consolidated financial statements. Certain of these policies involve critical accounting estimates because they require us to make particularly subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts could be reported under different conditions or using different assumptions. These estimates and assumptions are subject to change as new events occur, as more experience is acquired, as additional information is obtained and as the general operating environment changes.

We believe the following are the most critical accounting policies and estimates that we have used in the preparation of our financial statements.

Workers' Compensation Claims Liability

Our financial statements include an estimate of residual liability for workers' compensation claims arising from the Workers' Compensation Board ("WCB") deposit class coverage system, in which our predecessor entity participated on or prior to March 31, 2003.

The WCB provided our predecessor company with an actuarial valuation of the unfinalized claims remaining to be paid that relate to incidents on or prior to March 31, 2003. This estimate totalled $9.3 million at March 31, 2003 and is drawn down as claims are paid out. In fiscal 2007 we received an actuarial valuation estimating that the unfinalized claims remaining to be paid at March 31, 2006 totalled $4.7 million. As a result we reduced the current unfinalized claims liability and decreased expenses by $1.8 million during fiscal 2007. The remaining balance at March 31, 2007 of $3.6 million ($6.5 million at March 31, 2006) is included in accrued employee future benefits in our financial statements.

Public Service Pension Plan

Our employees are members of the Public Service Pension Plan (the "Plan"), a defined benefit and multiemployer pension plan. In April 2003, we were converted from a Crown corporation into an independent company incorporated under the provincial *Company Act*, and we now validly exist under the *Business Corporations Act* (British Columbia). In February 2004, our company and the union representing our employees jointly submitted a formal application for all our employees and our company to remain within the Plan. In March 2004, the Public Service Pension Board of Trustees agreed to the proposal.

The Plan is exempt from the requirements under the provincial *Pension Benefits Standards Act* to use the "solvency" method in conjunction with the "going concern" method for valuation purposes. As such, the Plan is currently valued solely by the going concern method. The most recent valuation of the total Plan, as at March 31, 2005, indicated an unfunded liability in the Basic Account of $767 million.

Effective April 1, 2006, the Public Service Pension Board of Trustees increased contribution rates for plan members and employers by 1.88% each, effectively eliminating the unfunded actuarial liability.

Retirement Bonus Liability

We sponsor a plan that provides a post-retirement benefit for long service employees. The valuation of this plan is estimated based on complex actuarial calculations using several assumptions. These assumptions are determined by management with significant input from our actuary. The valuation of the obligation depends on such assumptions as discount rate, projected salary increases, retirement age and termination rates. An actuarial valuation was obtained in March 2005 and the accrued benefit obligation estimated at $10 million. The liability included in accrued employee future benefits in our financial statements at March 31, 2007 was $9.9 million ($9.8 million at March 31, 2006).

We have adopted the corridor method of recognizing actuarial gains and losses. Any gains and losses in excess of 10% of the obligation balance will be amortized over the average remaining service period of employees expected to receive benefits under this plan.

Rate Regulation

We follow generally accepted accounting principles which, as we are a regulated entity, may differ from those otherwise expected in non-regulated businesses. These differences occur when the regulator issues orders and generally involve the timing of revenue and expense recognition. The principles we follow ensure that the actions of the regulator, which create assets and liabilities, have been reflected in the financial statements.

The accounting for these items is based on an expectation of the future actions of the regulator. As of March 31, 2007, we have four regulatory assets or liabilities:

- Deferred fuel costs: the difference between amounts allowed by the regulator in operating expense and those actually incurred with recovery expected through future tariffs or surcharges;
- Performance term submission costs: costs for incremental contracted services relating to our second performance term submission based on the expectation that our regulator will approve the recovery of these costs over our second performance term that begins April 1, 2008;
- Tariffs in excess of price caps: the amount by which average annual tariffs collected at a specific date exceed established price caps set under the terms of the *Coastal Ferry Act*. The excess amounts collected will be returned to customers through future tariffs;

- Hedge losses – vessel construction contracts: unrealized losses on financial derivative instruments not designated for hedge accounting purposes relating to the construction of our new northern vessel. These losses will ultimately form part of the capital cost of the new vessel.

If the regulator's future actions are different from our expectations, the timing and amount of the recovery of deferred costs could be substantially different from that reflected in our financial statements.

Amortization Expense

Our capital assets, including assets under capital leases, are amortized on a straight-line basis at varying rates. Amortization rates require the use of estimates of the useful lives of the assets and of salvage to be realized upon asset retirement.

We periodically review asset lives in conjunction with our longer term asset deployment, replacement and upgrade strategies. When we determine that asset lives do not reflect the expected remaining period of benefit, we make prospective changes to the remaining period over which they are amortized. There are a number of uncertainties inherent in estimating our asset lives and changes in these assumptions could result in material adjustments to our financial statements.

As disclosed in note 1 to our financial statements, we review and evaluate our long-lived assets for impairment when events or changes in circumstances indicate that the related amounts may not be recoverable.

Hedging Relationships

In April 2005, the Canadian Institute of Chartered Accountants ("CICA") issued Handbook Section 3865, replacing Accounting Guideline 13 which we had adopted on April 1, 2004. The new standard addresses the identification, designation, documentation and effectiveness of hedging transactions for the purpose of applying hedge accounting. It also identifies situations where hedge accounting is to be discontinued. Under this guideline, we are required to prepare formal documentation for each individual derivative in order to apply hedge accounting for positions hedged with derivatives.

During fiscal 2005, we elected to apply hedge accounting on the currency derivatives relating to the three new Super C-class vessels. During fiscal 2007, we elected to apply hedge accounting on the currency derivatives for the new *Northern Expedition* commencing October 16, 2006, the date at which formal documentation requirements were met. At March 31, 2007 we have recorded the $2.8 million fair market value of foreign currency derivatives (nil at March 31, 2006) at October 16, 2006 relating to the Northern Expedition. We have elected not to apply hedge accounting on fuel commodity derivatives, and therefore, we have recorded the $0.7 million fair market value of commodity derivatives in our balance sheet at March 31, 2007 ($0.9 million at March 31, 2006).

Asset Retirement Obligations

On April 1, 2004, we adopted the CICA new standard for recognition, measurement and disclosure of liabilities for asset retirement obligations and the associated asset retirement costs. Under the new standard the fair value of a liability for an asset retirement obligation must be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value is added to the carrying amount of the associated asset, which is then expensed over the asset's estimated useful life. The liability is accreted over the estimated useful life of the asset through charges to expenses.

As we are not aware of any future liabilities associated with the retirement of our assets, the adoption of this policy does not result in the recording of an asset retirement liability and therefore our financial statements have not been impacted by this standard. In addition, as our operations are regulated, there is a reasonable expectation that any significant asset retirement costs would be recoverable through future tariffs.

Future Accounting Changes

Financial Instruments, Comprehensive Income and Hedges

The CICA has issued new accounting standards relating to comprehensive income, equity, financial instruments and hedges. Under the new guidance all financial instruments, including derivatives, will be included on the balance sheet and measured, in most cases, at fair value. Certain gains and losses arising from changes in fair value will be temporarily recorded outside the income statement in comprehensive income. These gains and losses will be shown in the equity section under accumulated other comprehensive income. The new CICA Handbook sections also extend the requirements for hedge accounting. We will adopt these new standards for the first quarter of fiscal 2008. We are currently assessing the impact of adoption of these new requirements on our consolidated financial statements.

Rate Regulation

In May 2005, the CICA issued Accounting Guideline 19 to establish financial statement guidelines for entities subject to rate regulation. This guideline requires disclosure of general information regarding the nature and economic effects of rate regulation, as well as additional information on how rate regulation has affected the financial statements. The guideline did not address recognition and measurement issues associated with the accounting for rate-regulated operations. In March 2007, the Accounting Standards Board of the CICA released an exposure draft, "Rate-Regulated Operations" proposing revisions to the CICA Handbook.

The exposure draft proposes removal of all Handbook recognition and measurement guidance relating specifically to rate-regulated operations. Under these proposed changes and once the Handbook is amended, the US standard SFAS 71[3] would provide guidance for recognition and measurement. We believe that this will not have a material effect on our consolidated results of operations, financial position or cash flow statements.

SYSTEMS, PROCEDURES AND CONTROLS

We are responsible for establishing and maintaining disclosure controls and procedures to ensure that material information is recorded, processed, summarized and reported as required by applicable Canadian securities legislation. We have carried out an evaluation of the effectiveness as of March 31, 2007 of the design and operation of the disclosure controls and procedures. Based on this evaluation, the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") concluded that the disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed to satisfy continuous disclosure obligations and are effective in ensuring that information required to be disclosed is accumulated and communicated as appropriate to allow timely decisions regarding required disclosure.

We are responsible for designing and implementing internal controls over financial reporting to provide reasonable assurance regarding the reliability of the reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles. We have carried out a review of our internal controls over financial reporting as of March 31, 2007. Based on this evaluation, the CEO and CFO concluded that such internal controls have been designed to provide reasonable assurance regarding the reliability of the reporting and the preparation of financial statements for external purposes. There were no changes in internal control over financial reporting that occurred during the last quarter of fiscal 2007 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

CORPORATE STRUCTURE AND GOVERNANCE

Our Board of Directors and Management consider good corporate governance to be central to the effective, efficient and prudent operation of the Company. Both Management and the Board have monitored and, where appropriate, responded to regulatory developments aimed at improving corporate governance practices, increasing corporate accountability and enhancing the transparency of public company disclosure and will continue to monitor the developments in corporate governance practices.

In 2005, National Instrument 58-101 *Disclosure of Corporate Governance Practices* (the "Instrument") and a related National Policy 58-201 *Corporate Governance Guidelines* (the "Guidelines") issued by the Canadian Securities Administrators came into effect. The Guidelines and Instrument require reporting issuers to disclose annually their approach to corporate governance with reference to specific matters. See Schedule A for the disclosure in accordance with this Instrument.

FORWARD LOOKING STATEMENTS

This management's discussion and analysis contains certain "forward looking statements". These statements relate to future events or future performance and reflect management's expectations regarding our growth, results of operations, performance, business prospects and opportunities and industry performance and trends. They reflect management's current internal projections, expectations or beliefs and are based on information currently available to management.

In some cases, forward looking statements can be identified by terminology such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue" or the negative of these terms or other comparable terminology. A number of factors could cause actual events or results to differ materially from the results discussed in the forward looking statements. In evaluating these statements, prospective investors should specifically consider various factors including, but not limited to, the risks and uncertainties associated with traffic volume and tariff revenue risk, the impact of competition, asset risk, accident/casualty loss risk, tax risk, environmental risk, regulatory risk, labour disruption risk, risk of default under material contracts and aboriginal land claims.

Actual results may differ materially from any forward looking statement. Although management believes that the forward looking statements contained in this management's discussion and analysis are based upon reasonable assumptions, investors cannot be assured that actual results will be consistent with these forward looking statements. These forward looking statements are made as of the date of this management's discussion and analysis, and British Columbia Ferry Services Inc. assumes no obligation to update or revise them to reflect new events or circumstances.

[3]Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS 71), of the US Financial Accounting Standards Board.

Schedule A
CORPORATE STRUCTURE AND GOVERNANCE

Board of Directors

The Board has assumed responsibility for the stewardship of the Company by overseeing the conduct of the business, supervising Management, which is responsible for the day-to-day conduct of the business and endeavoring to ensure that all major issues affecting the business and affairs of the Company are given proper consideration.

At March 31, 2007, the Board was comprised of the following Directors:

Chair: Elizabeth J. Harrison Q.C.

Vice Chair: Thomas W. Harris

Members: Douglas E. Allen, Peter R.B. Armstrong, Sandy M. Fulton, David L. Hahn, John R. Henderson, Doreen J. Hewitt, Maureen V. Macarenko, Robert W. McCaskill, G. Raymond Whitehead, Graham M. Wilson

Effective April 1, 2007, Peter R.B. Armstrong ceased to be a Director and effective May 15, 2007, A. Daniel Miller became a Director.

The Board Governance Manual articulates the governance framework under which the Board fulfills its stewardship responsibilities. The Manual assembles in one document the essential elements for providing an appropriate level of governance for the organization. It includes, among other things, terms of reference for the Board, Chair, Directors, Committees and Committee Chairs and serves as a practical guide for the Board and Management in fulfilling their respective duties and responsibilities. The governance framework is a product and responsibility of the Board.

The Board is committed to the principles of independence and accountability. The Board has adopted policies and practices that ensure it has the capacity, independent of Management, to fulfill the Board's responsibilities, make objective assessments of Management and assess the merits of Management initiatives. The Governance and Human Resources Committee has an ongoing responsibility to ensure that the governance structures and processes continue to enable the Board to function independently.

The Board and Management recognize that there is a regular need for the Board to meet without Management in attendance. It is general practice to conduct a portion of every Board meeting with only independent directors present.

The Board and its Committees each have the authority to retain any outside advisor, at the Company's expense, that it determines to be necessary to permit it to carry out its duties.

The recruitment of directors is undertaken with the objective of ensuring the Board is composed of a majority of strong, qualified independent directors. The Board supports the concept that the role of the Board Chair is separate from that of the President & CEO and that the Board Chair should be an independent Director. These principles are reflected in the Board Governance Manual.

The Board has adopted a definition of an independent Director for members of the Audit and Finance Committee consistent with the definition of independence in Multilateral Instrument 52-110. This definition, with some modification that is consistent with Multilateral Instrument 52-110, also applies to determining the independence of other members of the Board.

The Board is responsible for determining whether directors are independent pursuant to the definition of independence adopted by the Board. To do this the Board requires members to disclose their relationships with the Company and its subsidiaries. These disclosures are reviewed by the General Counsel, the Corporate Secretary, the Chair of the Board and the Chair of the Governance and Human Resources Committee. Any director who is deemed independent and whose circumstances change such that he or she might be considered to no longer be an independent director is required to promptly advise the Board of the change in circumstances. Directors are required annually to attest to their independence in writing.

Mr. David L. Hahn, President & CEO, is the only director who is a member of Management of the Company. By virtue of his being a member of Management, Mr. Hahn is not independent. The other directors of the Company, including the Chair of the Board, have been determined by the Board to be independent pursuant to the definition of independence adopted by the Board.

Directorships

The following were directors of another issuer, other than British Columbia Ferry Services Inc. ("BCFS"), which is a reporting issuer (or the equivalent) in Canada or a foreign jurisdiction:

Elizabeth J. Harrison, Q.C.:	Director, Unilens Vision Inc.
Graham M. Wilson:	Director, ITRON Inc. Director, Naikun Wind Group Trustee and Director, Hardwoods Distribution Trust Trustee, Daylight Resources Trust

Orientation and Continuing Education

The Company has a variety of orientation and education programs in place for directors. These programs are aimed at increasing the directors' familiarity with the operation of the Company and its governance practices.

All new directors are provided with the opportunity to participate in an orientation program. The orientation program is tailored to the individual director's needs and areas of interest. The program generally involves a full day session, held prior to a new director attending his/her first BCFS Board meeting, during which the new director is briefed by members of senior management and receives written information about the business and operations of BCFS and Board governance practices, including the duties and obligations of directors. All new directors receive a copy of the Board Governance Manual. This provides a comprehensive overview of the roles and responsibilities of the Board, its Committees and the contributions expected by each director.

The Board recognizes the importance of ongoing director education and the need for each Director to take personal responsibility for this process. To facilitate ongoing education, the Board Chair and the Chair of the Governance and Human Resources Committee periodically canvas the directors to determine their training and education needs and interests; arrange ongoing visits by directors to the Company's facilities and operations; arrange for the attendance of directors at seminars or conferences of interest and relevance to their position as a director of the Company; and encourage and facilitate presentations by outside experts to the Board or Committees on matters of particular import or emerging significance. Directors are also provided with memberships in the Institute of Corporate Directors which provides them with opportunities to attend programs and courses relevant to corporate governance.

Responsibility for ensuring that orientation and ongoing education are provided to directors rests with the Chair of the Board. The Governance and Human Resources Committee has responsibility for reviewing the orientation and education programs to ensure they are effective and meet the needs of directors.

Ethical Business Conduct

The Board of Directors approved and adopted a Code of Business Conduct and Ethics ("Code") on November 10, 2004. Notice of adoption of the Code as Company policy was communicated to the Company's personnel by intra-Company information bulletin widely distributed throughout the Company. In addition, the Code has been posted on the Company's intranet website for Company personnel, and on the Company's internet site. The Code was filed on SEDAR on March 1, 2006. The Board has also adopted a Corporate Disclosure and Securities Trading Policy, which is also posted on the Company's intranet and internet sites.

As part of the Company's disclosure controls process, in conjunction with quarter-end financial reporting, appropriate Managers are required to make representations regarding compliance with the Code and the Corporate Disclosure and Securities Trading Policy.

As part of the communication process for the reporting of questionable accounting and auditing matters, a secure telephone line and a secure email address, each monitored by the Executive Director of Internal Audit, have been established and this has been communicated to Company employees by intra-Company information bulletin. The contact particulars are also posted with the Code on the Company's intranet site.

The Board, through the Audit and Finance Committee, monitors compliance with the Code through review of compliance reports received quarterly from Management, the External Auditors, and the Internal Auditors.

Directors and officers review the Code and acknowledge their support and understanding of the policy by signing an annual disclosure statement.

The Code requires that directors and officers disclose potential conflicts of interest at the time of their appointment and immediately upon a situation of a conflict of interest or potential conflict of interest arising. Such disclosures are communicated to and reviewed by the General Counsel, the Corporate Secretary, the Chair of the Board and the Chair of the Governance and Human Resources Committee.

Nomination of Directors

The B.C. Ferry Authority (the "BCFA"), through its Board of Directors, selects the Board of Directors of British Columbia Ferry Services Inc. ("BCFS") by March 31 each year. While not a requirement, it is current practice that the directors of BCFA will also be directors of BCFS.

The Articles of Incorporation of BCFS permit a total of 20 directors of BCFS, hence directors may be appointed to the Board of BCFS in addition to those who are also directors of BCFA. It is viewed as desirable to maintain consistency between the two Boards so that the interests of BCFA and BCFS are properly aligned. However, the ability to appoint additional directors to the Board of BCFS gives flexibility in ensuring adequate skill sets and experience are available within the members of the Board of BCFS.

The BCFS Board has established a Nominating Committee to lead the director nomination processes for BCFS.

The Nominating Committee is composed entirely of directors who are independent, pursuant to the definition of independence adopted by the Board of BCFS. The Chair of the Board of BCFS is the Chair of the Nominating Committee. Descriptions of the Nominating Committee's responsibilities, powers and operations are included in the Board Governance Manual.

Each year the skill sets and experience of the incumbents and any retiring directors of BCFS are reviewed by the Nominating Committee in the context of the skills and experience profile adopted by the BCFS Board and the ongoing governance needs of BCFS. Any gaps are identified. Potential conflicts of interest and other extenuating circumstances are also identified.

The skill sets and experience of the candidates for the BCFA Board that are put forward by the nominating entities and the Province are reviewed by the Nominating Committee to ascertain if there will be any gaps in the skill sets and experience of the Board of BCFS, assuming BCFA directors also become BCFS directors. If gaps are identified, the Nominating Committee, in consultation with the President & CEO, seeks out suitable candidates for nomination as directors of BCFS to fill such gaps.

The Nominating Committee makes recommendations to the BCFS Board of Directors on suitable candidates for appointment to the BCFS Board. These recommendations take into account the talents of the existing BCFS Board, and the talents of all nominees (including BCFA Board nominees and appointees who may become BCFS Board members, if applicable), taking the skills and experience profile established for BCFS directors into account.

The BCFS Board makes its decision on prospective directors and forwards its recommendations to the BCFA Board. The BCFA Board then determines the directors of BCFS and causes BCFA, as the sole holder of the single voting share of BCFS, to appoint such directors to the Board of BCFS.

Compensation

The Governance and Human Resources Committee reviews the compensation of directors and the President & CEO annually. The Committee is composed entirely of independent directors and operates under terms of reference adopted by the Board.

The Committee engages an external compensation advisor to research and provide independent advice to the Committee on the level and types of compensation for directors and the President & CEO. In making its recommendations to the Board, the Committee takes into account the types of compensation and the amounts paid by other comparable companies.

Board Committees

Audit and Finance Committee (at March 31, 2007):

Chair: Graham M. Wilson

Members: Douglas E. Allen; Thomas W. Harris; John R. Henderson, Maureen V. Macarenko

Effective April 1, 2007, Maureen V. Macarenko ceased to be a member of the Audit and Finance Committee and Robert W. McCaskill became a member of the Committee.

The Audit and Finance Committee ("Committee") is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:

- Review the financial reports and other financial information provided by the Company to its security holders;
- Review the annual operating and capital budgets, modifications thereto, and details of any proposed financing;
- Monitor the integrity of the financial reporting process and the system of internal controls that the Board and our management have established;
- Monitor the management of the principal risks that could impact the financial reporting of the Company, and the Company's compliance with legal and regulatory requirements as they relate to the Company's financial statements;
- Review and approve the audit plan, process, results, and performance of the Company's external auditors and the internal audit department ("the internal auditor") while providing an open avenue of communication between the Board, management, external auditors, and the internal auditor; and
- Assess the qualifications and independence of the external auditors, and recommend to the Board the nominations of the external auditors and the compensation to be paid to the external auditors.

The Committee has the authority to conduct any investigation appropriate to fulfilling its responsibilities, and it has direct access to the external auditors as well as anyone in the organization. The Committee has the authority to retain special legal, accounting, and other advisors or experts it deems necessary in the performance of its duties.

Each of the members of the Committee has been determined by the Board of Directors to be independent, that is, without any direct or indirect relationship with the Company that could reasonably interfere with the exercise of the member's independent judgment. Douglas E. Allen acted as interim Chief Executive Officer of the Company from October 16, 2002 until May 5, 2003.

All members of the Committee are financially literate within the meaning of Multilateral Instrument 52-110, that is, each has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the Company's financial statements.

Since April 1, 2005, all recommendations of the Committee to nominate or compensate an external auditor have been adopted by the Board.

The aggregate fees billed by our external auditor in each of the last two fiscal years were:

Year ended March 31 ($ thousands)	2007	2006
External Auditor Billings		
Audit and audit related	172.8	121.8
Tax services	3.0	10.4
All other fees		
Advisory services (internal control certification)	7.5	14.8
Enterprise Risk Management project	-	151.4
	183.3	298.4

Pursuant to its terms of reference, the Committee must pre-approve retaining the external auditors for any non-audit service to be provided to the Company or its subsidiaries, provided that no approval shall be provided for any service that is prohibited under the rules of the Canadian Public Accountability Board or the Public Company Accounting Oversight Board, or the Independence Standards of the Canadian Institute of Chartered Accountants.

Before retaining the external auditors for any non-audit service, the Committee must consider the compatibility of the service with the external auditors' independence. The Committee may pre-approve retaining of the external auditors for the engagement of any non-audit services by establishing policies and procedures to be followed prior to the appointment of the external auditors for the provision of such services. To date no such policies and procedures have been established. In addition, the Committee may delegate to one or more members the authority to pre-approve retaining of the external auditors for any non-audit services to the extent permitted by applicable law.

In addition to the Audit and Finance Committee, the Board has appointed the following three Committees, all of which are composed entirely of independent directors:

Governance and Human Resources Committee (at March 31, 2007):

Chair: Douglas E. Allen | **Members:** John R. Henderson, Doreen J. Hewitt, Robert W. McCaskill, Graham M. Wilson

Effective April 1, 2007, Robert W. McCaskill ceased to be a member of the Governance and Human Resources Committee and Sandy M. Fulton, Maureen V. Macarenko and G. Raymond Whitehead became members of the Committee.

The Governance and Human Resources Committee is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:

- review the policies and practices of the Board;
- ensure the Board's continuing ability to fulfill its legislative mandate;
- implement effective due diligence over the operations of the Company;
- review the human resources strategies of the Company, including management recruitment, development, retention, compensation, and succession planning;
- review and recommend to the Board the appointment of Officers of the Company; and
- review and recommend to the Board appropriate compensation for directors, the President & CEO and senior executive, and otherwise fulfill the responsibilities of a compensation committee.

Safety, Health, Environment and Security Committee (at March 31, 2007):

Chair: G. Raymond Whitehead | **Members:** Sandy M. Fulton, Maureen V. Macarenko, Robert W. McCaskill, Peter R. B. Armstrong

Effective April 1, 2007, G. Raymond Whitehead ceased to be Chair of the Safety, Health, Environment and Security Committee and Sandy M. Fulton became Chair of the Committee. Also effective April 1, 2007, Peter R. B. Armstrong ceased to be a Director and member of the Committee and Doreen J. Hewitt became a member of the Committee.

The Safety, Health, Environment and Security Committee is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:

- exercise due diligence over the safety, health, environmental and security operations of the Company;
- develop, review, and make recommendations, as required, on matters related to the Company's safety, health, environmental and security policies and practices; and
- monitor compliance with Government regulations and with the Company's commitment to these issues.

Nominating Committee (at March 31, 2007):

Chair: Elizabeth J. Harrison, Q.C. | **Members:** Douglas E. Allen, Sandy M. Fulton, Graham M. Wilson

The Nominating Committee is appointed by the Board of Directors and has a mandate to:

- assist the Board in ensuring that Board members collectively and individually have the skills, experience and backgrounds to appropriately lead the organization;
- establish and implement effective processes for identifying suitable candidates for appointment as Directors of BCFS; and
- recommend to the Board suitable candidates for appointment as Directors of BCFS.

Assessments

As part of its dedication to best governance practices, the Board is committed to regular assessments of the effectiveness of the Board, the Board Chair, Committees, Committee Chairs and individual directors.

The Governance and Human Resources Committee annually reviews and makes recommendations to the Board on the method and content for annual evaluations.

The evaluation method varies from year to year. In the previous three years, the board has engaged an independent governance consultant to coordinate the evaluation. The consultant has collected information on individual director's assessments of the performance of the board against its terms of reference, the Board Chair against the Board Chair's terms of reference, and each Committee, including the Committee Chair, against its terms of reference. The assessment undertaken in the year ended March 31, 2007 involved individual discussions between each director and the independent consultant on matters related to Board effectiveness. The consultant presented the results of the evaluation to the Governance and Human Resources Committee and the Board and has prepared recommendations for action. Considering the consultant's report and recommendations, the Governance and Human Resources Committee will prepare and implemented an action plan for the upcoming year. This action plan will be reviewed and approved by the Board.

The Board also undertakes an assessment of individual director performance annually. This occurs through in-depth discussions between individual directors and the Board Chair.

Consolidated Financial Statements

Management's Responsibility

BC Ferries management is responsible for presentation and preparation of the annual consolidated financial statements, management's discussion and analysis ("MD&A") and all other information in this annual report.

The accompanying consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The consolidated financial statements and information in the MD&A necessarily include amounts based on management's informed judgements and best estimates. The financial information presented elsewhere in this annual report is consistent with that in the consolidated financial statements.

To meet its responsibility for reliable and accurate financial statements, management has established systems of internal control that are designed to provide reasonable assurance that assets are safeguarded from loss and that reliable financial records are maintained. These systems are monitored by management and by internal auditors. In addition, the internal auditors perform appropriate tests and related audit procedures.

The consolidated financial statements have been examined by KPMG LLP, independent chartered accountants. The external auditors' responsibility is to express a professional opinion on the fairness of management's consolidated financial statements. The auditors' report outlines the scope of their examination and sets forth their opinion.

The Board of Directors, through its Audit and Finance Committee, oversees management's responsibilities for financial reporting and internal control. The Audit and Finance Committee meets with the internal auditors, the independent auditors and management to discuss auditing and financial matters and to review the consolidated financial statements and the independent auditors' report. The Audit and Finance Committee reports its findings to the Board for consideration in approving the consolidated financial statements for issuance.

David L. Hahn
President & Chief Executive Officer

Rob Clarke
Executive Vice President & Chief Financial Officer

Auditors' Report

To the Shareholders of British Columbia Ferry Services Inc.

We have audited the consolidated balance sheets of British Columbia Ferry Services Inc. as at March 31, 2007 and 2006 and the consolidated statements of earnings and retained earnings and cash flows for each of the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at March 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Victoria, Canada
May 17, 2007

Consolidated Financial Statements

Consolidated Balance Sheets **As at March 31 (expressed in thousands)**	**2007**	2006
Assets		
Current assets:		
Cash and cash equivalents (note 2(c))	$ 180,123	$ 2,291
Short-term investments (note 2(c))	16,046	14,988
Accounts receivable	19,050	21,227
Prepaid expenses	5,879	6,702
Inventories	16,492	17,885
	237,590	63,093
Capital assets (note 3)	918,824	711,248
Deferred financing costs	9,580	8,183
Regulatory assets (note 4)	21,721	22,783
Long-term land lease (note 5)	28,060	28,370
	$ 1,215,775	$ 833,677
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 72,511	$ 69,326
Short-term debt (note 2)	24,888	-
Interest payable on long-term debt	12,663	12,251
Accrued employee costs	47,393	44,810
Deferred revenue	12,031	14,000
Regulatory liabilities (note 4)	90	958
Current portion of accrued employee future benefits	800	800
Current portion of obligations under capital lease	26	25
	170,402	142,170
Accrued employee future benefits (note 6)	13,755	16,737
Unrealized losses on derivative instruments (note 7)	2,831	-
Long-term debt (note 2)	749,628	499,604
Obligations under capital lease (note 8)	112	138
	936,728	658,649
Shareholders' equity:		
Share capital (note 9)	75,478	75,478
Retained earnings	203,569	99,550
	279,047	175,028
Commitments (notes 3 and 14)		
Contingent liabilities (note 17)		
	$ 1,215,775	$ 833,677

See accompanying notes to consolidated financial statements.

On behalf of the Board:

Director, Graham M. Wilson

Director, Elizabeth J. Harrison, QC

Consolidated Statements of Earnings and Retained Earnings **As at March 31 (expressed in thousands)**	**2007**	2006
Revenue:		
Tariffs	$ 363,228	$ 353,624
Ferry service fees (note 10)	108,396	108,223
Federal-Provincial Subsidy Agreement (note 11)	25,309	24,890
Retail	71,719	68,749
Other income	27,627	23,676
	596,279	579,162
Expenses:		
Operations	309,121	291,771
Maintenance	84,886	81,081
Administration	50,615	51,181
Cost of retail goods sold	28,226	26,977
Amortization	55,515	53,106
	528,363	504,116
Earnings from operations	67,916	75,046
Gain on foreign exchange	344	249
Interest expense (note 12)	(19,292)	(25,128)
Loss on disposal and write-down of capital assets	(183)	(302)
Net earnings before extraordinary gain	48,785	49,865
Extraordinary gain (note 13)	61,272	-
Net earnings	110,057	49,865
Retained earnings, beginning of year	99,550	55,723
Preferred share dividend (note 9)	(6,038)	(6,038)
Retained earnings, end of year	$ 203,569	$ 99,550

See accompanying notes to consolidated financial statements.

Consolidated Financial Statements

Consolidated Statements of Cash Flows **Years ended March 31 (expressed in thousands)**	**2007**	2006
Cash provided by (used in):		
Operations:		
Net earnings before extraordinary gain	$ 48,785	$ 49,865
Extraordinary gain (note 13)	61,272	-
Net earnings	110,057	49,865
Items not involving cash:		
Amortization	55,515	53,106
Other non-cash charges	(1,897)	1,079
Regulatory costs deferred	3,893	(14,783)
Change in operating working capital	(7,108)	9,485
	160,460	98,752
Financing:		
Dividends paid on preferred shares	(6,038)	(6,038)
Deferred financing costs incurred	(1,895)	(692)
Proceeds from issuance of bonds	250,000	-
Proceeds from short-term loans	203,843	-
Repayment of short-term loans	(179,135)	-
	266,775	(6,730)
Investing:		
Proceeds from disposal of capital assets	31	7
Purchase of capital assets	(248,316)	(130,181)
Increase in lands under long-term lease	(60)	(1,147)
(Purchase) redemption of short-term investments	(1,058)	66
	(249,403)	(131,255)
Increase (decrease) in cash and cash equivalents	177,832	(39,233)
Cash and cash equivalents, beginning of year	2,291	41,524
Cash and cash equivalents, end of year	$ 180,123	$ 2,291
Supplemental cash flow information:		
Cash paid during the year for interest	$ 31,202	$ 30,175

See accompanying notes to consolidated financial statements.

British Columbia Ferry Services Inc. (the "Company") was incorporated under the *Company Act* (British Columbia) by way of conversion on April 2, 2003, and now validly exists under the *Business Corporations Act* (British Columbia). The Company's primary business activity is the provision of coastal ferry services in British Columbia.

The Company is subject to the *Coastal Ferry Act* (the "Act"), which came into force on April 1, 2003. Its common share is held by the British Columbia Ferry Authority, a corporation without share capital, and it is regulated by the British Columbia Ferries Commissioner (the "Commissioner") to ensure that rates are fair and reasonable and to monitor service levels.

1. Significant accounting policies:

(a) Basis of presentation:

The consolidated financial statements of the Company are prepared in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Deas Pacific Marine Inc. ("DPMI"), Catamaran Ferries International Inc. ("CFI"), Pacific Marine Leasing Inc. ("PMLI"), BCF Captive Insurance Company Ltd. ("BCF Captive") and Pacific Marine Ventures Inc ("PMV"). All inter-company balances and transactions have been eliminated on consolidation. CFI was dissolved on April 1, 2006 and DPMI was dissolved on April 1, 2007. PMLI commenced operations in January 2007. BCF Captive was incorporated in March 2005, and commenced operations April 1, 2005. PMV was incorporated on March 15, 2007 and has been inactive to date.

(b) Regulation:

The Company is regulated by the Commissioner to ensure that tariffs are fair and reasonable and to monitor service levels. In order to recognize the economic effects of regulation, the timing of recognition of certain revenues and expenses may differ from that otherwise expected under generally accepted accounting principles. These timing differences give rise to regulatory assets and regulatory liabilities in the financial statements.

The Company follows Accounting Guideline 19 "Disclosures by Entities Subject to Rate Regulation" (AcG-19) of the CICA Handbook (Handbook) which establishes guidelines on certain aspects of the disclosure and presentation of information in the financial statements of entities subject to rate regulation. AcG-19 requires the disclosure of general information regarding the nature and economic effects of rate regulation, as well as, additional information on how rate regulation has affected the financial statements (note 4). The guideline does not address recognition and measurement issues associated with the accounting for rate-regulated operations.

(c) Cash and cash equivalents:

Cash and cash equivalents are comprised of cash and investments that are highly liquid in nature and generally have a maturity date of three months or less.

(d) Short-term investments:

Short-term investments are valued at the lower of cost or market value and consist of financial instruments with original maturity dates greater than three months.

(e) Inventories:

Inventories, which consist of materials and supplies, catering stores and fuel, are valued at the lower of weighted-average cost and current replacement cost.

(f) Capital assets:

The costs of major replacements, additions, extensions and improvements, including direct overhead and financing costs during construction are capitalized. The costs of maintenance, repairs, refit and minor renewals or replacements are expensed as incurred.

Capital assets, including assets under capital leases, are amortized on a straight-line basis over the estimated useful lives of the assets at the following rates:

Asset class	Estimated useful life
Ship hulls	40 years
Ship propulsion and utility systems	20 to 30 years
Marine structures	20 to 40 years
Buildings	20 to 40 years
Equipment and other	3 to 20 years

(g) Impairment of long-lived assets:

The Company reviews capital assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparison of their carrying amount to the future undiscounted cash flows the assets are expected to generate. If such capital assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying amount of the assets exceeds their fair market value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

(h) Revenue recognition:

Tariff revenue is recognized when transportation is provided. The value of pre-sold vouchers is included in the balance sheets as deferred revenue.

(i) Pension and other employee future benefit plans:

Defined contribution plan accounting is applied to the Company's multiemployer defined benefit pension and long-term disability plans. These multiemployer plans are administered by external parties and the Company does not have sufficient information to apply defined benefit plan accounting.

The actuarial determination of the accrued benefit obligations for retirement benefits other than pension uses the projected benefit method prorated on service (which incorporates management's best estimate of future salary levels, other cost escalation, retirement ages of employees and other actuarial factors).

For the purpose of calculating the expected return on plan assets, those assets are valued at fair value.

Actuarial gains (losses) arise from the difference between actual long-term rate of return on plan assets for a period and the expected long-term rate of return on plan assets for that period or from changes in actuarial assumptions used to determine the accrued benefit obligation. For the Company's retirement bonus and death benefit plans, the excess of the net accumulated actuarial gain (loss) over 10 percent of the greater of

the benefit obligation and the fair value of plan assets is amortized over the average remaining service period of active employees. The average remaining service period of the active employees covered by the other (non-pension) retirement benefits plan was 7.5 years as at March 31, 2005, the date of the most recent actuarial valuation.

Past service costs arising from plan amendments are deferred and amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment.

When the restructuring of a benefit plan gives rise to both a curtailment and a settlement of obligations, the curtailment is accounted for prior to the settlement.

(j) Use of estimates:

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of management estimates relate to the valuation of assets held for resale, the economic life of capital assets and the corresponding period of amortization, the recoverability of capital assets, the valuation of employee future benefits, and provisions for contingencies. Actual results could differ from these estimates.

(k) Taxes:

The Company is a "Tax Exempt Corporation" as described in the Income Tax Act and as such, is exempt from federal and provincial income taxes.

The provision of vehicle and passenger ferry services is an exempt supply under the *Excise Tax Act* for GST purposes.

(l) Foreign currency transactions:

The Company's normal operating currency is the Canadian dollar. Monetary assets and liabilities denominated in foreign currency are translated to Canadian dollars at the rate of exchange prevailing at the balance sheet date. Revenues and expenses are translated at rates in effect at the time of the transaction. Foreign exchange gains and losses are recognized in the statement of earnings during the year in which they arise.

(m) Deferred financing costs:

Legal and financing costs incurred are capitalized and amortized on a straight-line basis over the life of the financing.

(n) Hedging relationships:

Derivative financial instruments are utilized by the Company to manage market risk against the volatility in foreign currency, interest rate, and fuel price exposures. The Company does not utilize derivative financial instruments for trading or speculative purposes. At the inception of each hedge the company determines whether it will or will not apply hedge accounting.

When applying hedge accounting, the Company documents all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedge transactions. This process includes linking all derivatives to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also assesses, both at the hedge inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of hedged items.

Realized and unrealized gains or losses associated with derivative instruments which have been terminated or cease to be effective prior to maturity are recognized in the period in which they have been terminated or cease to be effective.

(o) Asset retirement obligations:

In the period when it can be reasonably determined, the Company recognizes a liability at its fair value for any legal obligations associated with the retirement of long-lived assets when those obligations result from the acquisition, construction, development or normal operation of the assets. A corresponding asset retirement cost is added to the carrying amount of the related asset and amortized to expense on a systematic and rational basis.

It is possible that the Company's estimates of its ultimate asset retirement obligations could change as a result of changes in regulations, changes in the extent of environmental remediation required, changes in the means of reclamation or changes in cost estimates. Changes in estimates are accounted for prospectively from the period the estimate is revised.

The Company's long-lived assets include certain vessels which contain undetermined amounts of asbestos. Under certain circumstances the Company may be required to handle and dispose of the asbestos in a manner required by regulations. It is the Company's intention to sell decommissioned vessels into world markets for continued use in providing commercial ferry service. Under these circumstances asbestos remediation would become the responsibility of the new owner.

No amount has been recorded for asset retirement obligations relating to these assets as it is not possible to make a reasonable estimate of the fair value of any such liability due to the indeterminate magnitude, likelihood or financial impact, if any, of this issue.

(p) Interest rate support:

The Company receives interest rate support from the Government of Canada for eligible new Canadian built vessels or major refurbishment of vessels. Amounts receivable in regard to capitalized interest are recognized as a reduction of capitalized interest upon completion of the project. Amounts receivable in regard to post-completion debt service costs are recognized as a reduction to interest expense.

(q) Comparative figures:

Certain comparative figures have been reclassified to conform to the presentation adopted for the current period.

2. Loans:

As at March 31	2007	2006
Long–term debt:		
5.74% Senior Secured Bonds, Series 04-1, due May 2014 (a)	$ 250,000	$ 250,000
Unamortized discount	(95)	(108)
	249,905	249,892
6.25% Senior Secured Bonds, Series 04-4, due October 2034 (a)	250,000	250,000
Unamortized discount	(277)	(288)
	249,723	249,712
5.021% Senior Secured Bonds, Series 07-1, due March 2037 (a)	250,000	-
	$ 749,628	$ 499,604

In May 2004, the Company entered into a master trust indenture which established common security and a set of common covenants for the benefit of all lenders under the Company's financing plan. The financing plan encompasses an ongoing program capable of accommodating a variety of corporate debt instruments and borrowings ranking pari passu. Currently, the Company has issued three bond series and entered into a credit facility. In addition, the Company has entered into loan agreements which make up to $180 million available to finance the Company's purchase of two "Super C" Class vessels. These funds will be released to coincide with the conditional acceptance dates of the vessels, expected in 2008. The master trust indenture requires the Company to maintain a debt service reserve.

(a) Bonds:

Bonds are issued under supplemental indentures either as obligation bonds or as pledged bonds. The bonds are secured by a registered first mortgage and charge over vessels, an unregistered first mortgage and charge over ferry terminal leases, and by a general security agreement on property and contracts. The bonds are redeemable in whole or in part at the option of the Company. Interest on the Series 04-1 bonds is payable semi-annually on May 27 and November 27 of each year until maturity. Interest on the Series 04-4 bonds is payable semi-annually on April 13 and October 13 of each year until maturity. Interest on the Series 07-1 bonds is payable semi-annually on March 20 and September 20 of each year until maturity.

(b) Credit facility:

In May 2006 the Company renegotiated the credit facility with a syndicate of Canadian banks, secured by pledged bonds. The facility makes available to the Company a five year revolving credit facility in the amount of $155 million. Draws on this facility via 3 month Bankers' Acceptances total $25.0 million at March 31, 2007 (2006: nil), and are shown as short-term debt at their discounted value of $24.9 million. The effective interest rate of these borrowings was 4.77%. Interest on these draws recorded as expense during the year ended March 31, 2007 was $1.1 million (2006: nil).

(c) Debt service reserve:

The Company is required to maintain a debt service reserve for the Series 04-1, 04-4 and 07-1 bonds equal to not less than six months forecasted debt service, to be increased under certain conditions. Debt service reserves of $21.3 million are currently invested in cash and cash equivalents and short-term investments.

3. Capital assets:

March 31, 2007	Cost	Accumulated amortization	Net book value
Ships owned	$ 1,006,968	$ 522,112	$ 484,856
Berths, buildings and equipment	102,894	70,273	32,621
Berths, buildings and equipment under capital lease	488,098	225,414	262,684
Land	1,406	-	1,406
Construction-in-progress	137,257	-	137,257
	$ 1,736,623	$ 817,799	$ 918,824

March 31, 2006	Cost	Accumulated amortization	Net book value
Ships owned	$ 788,383	$ 472,110	$ 316,273
Ships under capital lease	60,421	19,026	41,395
Berths, buildings and equipment	95,646	61,080	34,566
Berths, buildings and equipment under capital lease	446,388	215,276	231,112
Land	1,107	-	1,107
Construction-in-progress	86,795	-	86,795
	$ 1,478,740	$ 767,492	$ 711,248

For the year ended March 31, 2007 capitalized financing costs during construction amounted to $6.7 million (2006: $2.7 million).

The *Queen of Oak Bay* was included in the ships under capital lease category in the year ended March 31, 2006; title passed to the company on January 1, 2007 and the *Queen of Oak Bay* is now included in the ships owned category.

Amortization expense for assets under capital lease for the year ended March 31, 2007 amounted to $12.7 million (2006: $15.0 million).

In addition to the construction-in-progress referenced above, contractual commitments, at March 31, 2007 for capital assets to be constructed totaled $489.8 million (2006: $324.2 million). Included in the contractual commitments as at March 31, 2007 is $293.5 million (2006: $308.2 million) committed for design and construction of three "Super C" Class vessels, $126.5 million (2006: nil) for design and construction of a new vessel for use on the north coast, and $36.3 million (2006: nil) committed to procure an intermediate class vessel. Delivery of the three "Super C" vessels is scheduled to occur during the period from late 2007 to mid 2008 while delivery of the intermediate class vessel and the new north coast vessel is scheduled to occur in mid 2008 and mid 2009, respectively.

4. Financial statement effect of rate regulation:

The Company is regulated by the Commissioner to ensure that tariffs are fair and reasonable and to monitor service levels. Under the terms of the Act, the tariffs the Company charges its customers are subject to price caps. Annual increases in price caps have been set for the first five year term through March 31, 2008. The Commissioner may, under certain circumstances, allow increases in price caps over the set levels. The Commissioner will establish the price caps to apply for each subsequent term.

The accounting for regulated operations of the Company may differ from non-regulated businesses following Canadian generally accepted accounting principles (GAAP). As a result, the Company records assets and liabilities that result from the regulated price cap setting process that would not be recorded under GAAP for non-regulated entities. Regulatory assets generally represent incurred costs that have been deferred because they are probable of future recovery in tariffs. Regulatory liabilities represent obligations to customers which will be settled through future tariffs. Management continually assesses whether the regulatory assets are probable of future recovery by considering factors such as applicable regulatory changes and believes the existing regulatory assets are probable of recovery. This determination reflects the current regulatory climate, and is subject to change in the future. If future recovery of costs ceases to be probable, asset write-offs would be required to be recognized in the current period earnings at that time.

Accounting for the impacts of rate regulation has resulted in recording the following regulatory assets and liabilities in the consolidated balance sheets:

As at March 31	2007	2006
Regulatory assets		
Deferred fuel costs (a)	$ 18,819	$ 22,715
Performance term submission costs (b)	532	68
Hedge losses – vessel construction contracts (c)	2,370	-
Total regulatory assets	$ 21,721	$ 22,783
Regulatory liabilities		
Tariffs in excess of price cap (d)	$ 90	$ 958

(a) Deferred fuel costs:

As prescribed by regulatory order, the Company defers fuel costs in excess of approved fuel costs which were used to develop the regulated price caps. The difference between the approved fuel costs and the actual fuel costs (including fuel hedge gains and losses) is deferred for recovery from future tariffs. The order also allows interest to be included in the amount to be recovered. Also prescribed by regulatory order, the Company collects fuel surcharges which are applied against deferred fuel costs. It is expected that the recovery period of deferred fuel costs will be up to five years. During March 2007 the Province of British Columbia entered into an agreement with the Company to make a one time payment of $7.0 million to be applied against the balance of deferred fuel costs. If the Company was not a regulated entity, earnings for the year ended March 31, 2007 would have been $3.9 million higher (2006: $14.7 million lower), except for this deferral.

(b) Performance term submission costs:

The Commissioner has authorized the Company to defer costs of representation associated with the second performance term. The Commissioner will consider these costs in the determination of the price caps set for the four years beginning April 1, 2008. The Commissioner has not included an allowance for a return on investment for this item. It is expected that the recovery period will be the four year period of the second performance term, commencing April 1, 2008. If the Company was not a regulated entity, earnings for the year ended March 31, 2007 would have been $0.4 million lower (2006: $0.1 million lower), except for this deferral.

(c) Hedge losses – vessel construction contracts

The Company defers hedge gains or losses on financial derivative instruments not designated for hedge accounting purposes and which have been entered into to manage market risk against fluctuations in the Canadian dollar equivalent of vessel construction contracts denominated in foreign currencies. The intent and effect of these transactions is to provide greater certainty of the cost of the related new vessel acquisitions. The total cost of these assets, including hedge gains or losses, has been determined by the Commissioner to be reasonable and will be taken into account in the determination of price caps set for the periods following the entry of these assets into service. It is expected that the settlement or recovery period of hedge gains or losses is five to forty years. If the

Company was not a regulated entity earnings for the year ended March 31, 2007 would have been $2.4 million lower (2006: nil), except for this deferral.

(d) Tariffs in excess of price cap:

The Act contains provisions which ensure that if tariffs charged by the Company exceed established price caps, the excess amounts collected will be returned to customers through future tariffs. At March 31, 2006, tariffs charged to customers on the major route group exceeded the price cap by $1.0 million. This liability was returned to customers through tariffs during the fiscal quarter ending June 30, 2006. At March 31, 2007 the tariffs charged to customers on the Bear Cove – Mid Coast route group exceed the price cap by $0.1 million (2006: nil). These excess amounts are expected to be returned to customers during the next operating period for this route group. In the absence of rate regulated accounting, GAAP would require these revenues to be recognized as income in the period collected, and earnings for the year ended March 31, 2007 would have been $0.9 million lower (2006: $1.0 million higher), except for this deferral.

5. Long-term land lease:

On April 1, 2003, the Company's land and structures comprising its terminals were transferred by the Company to the BC Transportation Financing Authority ("BCTFA"), a British Columbia Crown Corporation and related party at the time of the transaction. In exchange, the Company received recognition of a prepayment for leases of the transferred terminal structures and land. The structures, having lives of less than the lease term, are considered a capital lease and, as such, have been capitalized and included with capital assets and are amortized in accordance with the Company's amortization policy.

The land, having an indefinite useful life, is considered an operating lease. The prepayment of the land lease has been deferred and will be amortized on a straight-line basis over eighty years, being the initial sixty year lease period, plus an additional twenty year bargain renewal option.The transaction is reflected at the book values of the transferred terminal structures and land.

During the year ended March 31, 2005, the Company entered into an agreement with BCTFA in which the Company would make improvements to the highways approaching Horseshoe Bay and Swartz Bay terminals in exchange for increased lands under the existing land lease. As at March 31, 2006, the improvements were complete. Long-term land lease was increased by the cost of these highway improvements. The increases to long-term land lease are being amortized over the remaining lease period, commencing the month following completion of improvements.

6. Accrued employee future benefits:

(a) Description of benefit plans:

The Company and its employees contribute to the Public Service Pension Plan (the "Plan"). The Pension Corporation of the Province of British Columbia administers the Plan, including the payment of retirement and post-employment benefits on behalf of employers. The Plan is a multiemployer defined benefit pension plan. Under joint trusteeship, which became effective January 1, 2001, the risk and reward associated with the Plan's unfunded liability or surplus is shared between the employers and the plan members and will be reflected in their future contributions.

In addition, eligible employees are entitled to other retirement and future benefits as provided for under the collective agreement and terms of employment. A retirement bonus and a death benefit, both unfunded defined benefit plans, and both administered by the Company, are based on years of service and final average salary. A funded long-term disability multiemployer plan provides disability income benefits after employment, but before retirement.

The Company also administers an unfunded accumulated sick leave bank ("Sick Bank obligation"), consisting of unused sick time credits, earned prior to the discontinuation of the sick leave accumulation benefit, in 1979. Accumulated sick leave may be drawn down at 100%, or paid out at 50%. Benefits are paid out at current salary rates. No new credits are accumulated to this bank.

The Company's employees may also receive compensation benefits arising from claims prior to March 31, 2003 administered by the Workers' Compensation Board ("WCB obligation"). Prior to March 31, 2003, the Company participated in the Workers' Compensation Board deposit class coverage system. Subsequent to March 31, 2003 the Company has been covered under the Workers' Compensation Board rate system. The change to the rate system resulted in a residual liability from the deposit class system that has been valued by actuarial assumptions as appropriate for a closed plan. Currently this obligation is unfunded

(b) Total cash payments:

Total cash payments for employee future benefits for the year ended March 31, 2007, consisting of cash contributed by the Company to its multiemployer defined benefit plans, cash payments directly to beneficiaries for its unfunded other benefit plans, and cash contributed to a third party administrator of an unfunded plan, was $20.7 million (2006: $17.6 million).

(c) Defined benefit plans:

All of the Company's defined benefit plans, except its multiemployer plans, are currently unfunded. The most recent actuarial valuation of the retirement bonus and death benefit plans is as at March 31, 2005, with the next valuation expected as of March 31, 2008. The most recent actuarial valuations of the WCB obligation and the Sick Bank obligation are as at March 31, 2006 and March 31, 2001, respectively.

Other benefit plans

Accrued benefit obligations	2007	2006
Balance, beginning of year	$ 18,378	$ 18,276
Current service cost	481	493
Interest cost	783	816
Benefits paid	(2,418)	(1,156)
Actuarial (gains) losses	(1,780)	(51)
Balance, end of year	$ 15,444	$ 18,378
Reconciliation of funded status of the benefit plans to the amounts recorded in the financial statements		
Fair value of plan assets	$ -	$ -
Accrued benefit obligation	15,444	18,378
Funded status of plans – deficit	(15,444)	(18,378)
Unamortized net actuarial loss	889	841
Accrued benefit liability	(14,555)	(17,537)
Current portion of accrued employee future benefits	800	800
Accrued employee future benefits	$ (13,755)	$ (16,737)
Elements of defined benefit costs recognized in the year		
Current service cost, net of employee contributions	$ 481	$ 493
Interest cost	735	771
Actuarial (gains) losses	(1,780)	(51)
Defined benefit costs recognized	$ (564)	$ 1,213
Significant assumptions The significant assumptions used are as follows (weighted average):		
Accrued benefit obligation as of March 31:		
Discount rate	5.6%	4.6%
Rate of compensation increase	2.0%	2.0%
Annual employee retention rate	92.0%	92.0%
Employees with eligible dependents at pre-retirement death	43.0%	43.0%
Benefit cost for years ended March 31:		
Discount rate	5.6%	4.5%
Rate of compensation increase	2.0%	2.0%
Annual employee retention rate	92.0%	92.0%
Employees with eligible dependents at pre-retirement death	43.0%	43.0%

(d) Multiemployer plans:
The total cost recognized for the Company's multiemployer plans is as follows:

	2007	2006
Public Service Pension Plan contributions (i)	$ 16,222	$ 14,237
Long-term disability plan contributions	2,097	2,183
Long-term disability plan amortization of surplus (ii)	64	64
	$ 18,383	$ 16,484

i) The March 31, 2005 actuarial valuation report for the Public Service Pension Plan was received by the Public Service Pension Board of Trustees on December 14, 2005. This report indicated that the pension fund has an unfunded liability of $767 million. Under the terms of the plan's joint trust agreement, plan members and employers share in any increase or decrease in contribution rates. In order to address the unfunded liability, the plan trustees have increased the member and employer contribution rates by 1.88%, effective April 1, 2006.

ii) Contribution rates for the long-term disability plan are actuarially determined every three years as a percentage of covered payroll. The most recent valuation, as at March 31, 2005, determined a fund deficit, which is being amortized over a period of ten years, via an increase in the employer contribution rate. The next valuation will be as at March 31, 2008.

7. Unrealized losses on derivative instruments:

The carrying value as at March 31, 2007 of financial derivative instruments not initially designated as foreign currency hedges is $2.8 million (2006: nil), all of which was recognized during the current fiscal year.

8. Obligations under capital lease:

During the year ended March 31, 2005, the Company entered into a lease agreement for a training facility. The initial lease period is for a term of ten years, expiring April, 2015. The Company may, at its option, extend the lease term for up to two periods of five years each. Use of the facility by other organizations is controlled by the Company during the lease period. A discount rate of 6.25% has been used to determine the present value of the obligation under capital lease.

Future minimum lease payments:

Year ended	
2008	$ 66
2009	66
2010	66
2011	66
2012	66
Thereafter	84
Executory costs and imputed interest included in payments	(276)
	138
Current portion of capital lease liability	(26)
	$ 112

9. Share capital:

(a) Authorized:

1,000,000	Class A voting common shares, without par value
1	Class B voting common share, without par value
80,000	Class C non-voting, 8% cumulative preferred shares, with a par value of $1,000 per share, convertible to Class A shares upon the sale of the outstanding Class B share by the initial shareholder. Special rights attached to the Class C shares restrict the Company's ability to issue shares and to declare dividends.

(b) Issued and outstanding:

As at March 31	2007		2006	
	Number of shares	$ Amount	Number of shares	$ Amount
Class B, common	1	$ 1	1	$ 1
Class C, preferred	75,477	75,477	75,477	75,477
		$ 75,478		$ 75,478

(c) Dividends:

Dividends on the Class C cumulative preferred shares, if declared, are payable annually on March 31 of each year. All dividend entitlements to date have been paid.

10. Ferry service fees:

The Company entered into an agreement with the Province of British Columbia commencing April 1, 2003 to provide ferry services that would not be commercially viable under the current regulated tariff structure. In exchange for fees, the Company provides agreed ferry service levels on specified routes and administers certain social policy initiatives on behalf of the Province. The agreement is for a period of sixty years, the details of which are renegotiated after a first term of five years and each four-year term thereafter. During the year ended March 31, 2007 the agreement was amended and the province agreed to increase fees for provision of ferry service on northern routes commencing April 1, 2007.

11. Federal-Provincial Subsidy Agreement:

The Company receives revenue provided to the Province of British Columbia from the Government of Canada pursuant to a contract between the federal and provincial governments for the provision of ferry, coastal freight and passenger services in the waters of British Columbia. The annual payment increases with the Vancouver Consumer Price Index.

12. Interest rate support:

The Government of Canada has agreed to provide $9.9 million in the form of interest rate support to the Company for major refurbishments on three vessels (2006: $5.6 million). For the year ended March 31, 2007, $0.5 million has been recorded as a reduction of capitalized interest (2006: $0.6 million) and $4.7 million has been recorded as a reduction of interest expense (2006: $2.0 million). The remaining $2.1 million will be recognized over the next nine months as a reduction of interest expense.

The Company has no requirement to repay these funds, other than as a result of an event of default under the agreement with the Government of Canada.

13. Extraordinary gain:

On March 22, 2006 the vessel *Queen of the North* ran aground and subsequently sank. During the fiscal quarter ended June 30, 2006, the Company settled with its hull and machinery insurance providers and received insurance proceeds, net of deductible, of $67.9 million in settlement of the claim. At March 31, 2006, $6.6 million of the proceeds from this claim had been recognized to offset insurable losses (including $4.3 million net book value of capital assets) incurred as a result of this event.

14. Other commitments:

The Company has entered into agreements to lease computer hardware and software and to implement business and technology solutions. Commitments made under these agreements for the years ended March 31, 2008 and 2009 total $8.3 million and $1.3 million, respectively.

15. Risk management:

(a) Fuel management:

The Company may manage its exposure to vessel fuel price volatility by entering into swap agreements with certain financial intermediaries in order to add a fixed component to the inherent floating nature of fuel prices. When fuel hedging instruments are used, it is solely for the purpose of reducing fuel price risk, not for generating trading profits. Gains and losses resulting from the contracts are recognized as a component of fuel costs (also see note 4).

(b) Credit and interest rate risk:

Management does not believe that the Company is subject to any significant concentration of credit risk. Most of the Company's receivables result from tickets sold to passengers through the use of major credit cards. These receivables are short-term, generally being settled shortly after sale. The Company manages the credit exposure related to financial instruments by selecting credit-worthy counter-parties and by limiting its exposure to a single counter-party.

The Company may enter into interest rate agreements to manage its exposure on debt instruments. As at March 31, 2007, the Company has no interest rate agreements.

(c) Foreign exchange risk:

The Company may enter into foreign exchange forward contracts to manage its exposure on future purchase commitments. As at March 31, 2007, the Company, has entered into foreign exchange forward contracts valued at Cdn $586.8 million that are payable in Euros (2006: $449.9 million). Of these contracts, $416.8 million (2006: $449.9 million) is for the committed cost, including customs and duty of the three new "Super C" Class vessels, and $170.0 million (2006: nil) is for the committed cost, including customs and duty of the new Northern vessel.

(d) Fair value of financial instruments:

The fair value of financial instruments not currently carried at market value is summarized in the following table. Judgement is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates determined as of March 31, 2007 and 2006, are not necessarily indicative of the amounts the Company could have realized in current markets.

Fair market values have been estimated by reference to quoted market prices for the actual or similar instruments where available. The fair values of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities, short-term debt, accrued employee costs, and interest payable on long-term debt approximate their carrying amounts due to their short term to maturity.

As at March 31, 2007, the Company had outstanding fuel hedges with a notional amount of $5.8 million (2006: $19.3 million) which are marked to market and recognized in the consolidated financial statements at a value of $0.7 million (2006: $0.9 million).

The carrying values and approximate fair market values of the Company's longer term financial instruments are:

As at March 31	2007		2006	
	Carrying Value	Approx FMV	Carrying Value	Approx FMV
Liabilities:				
Long-term debt	$ 749,628	$ 804,155	$ 499,604	$ 552,968
Foreign currency forward contracts	-	10,052	-	45,300
Obligations under capital lease	138	138	163	163

16. Related party transactions:

In accordance with the Act, the Company is responsible for paying any expenses that are incurred by its parent, British Columbia Ferry Authority ("BCFA"), without charge. During the year ended March 31, 2007, the Company paid $14,437 (2006: $99,702) of such expenses.

The Province of British Columbia owns the Company's 75,477 non voting preferred shares, but has no voting interest in either the Company or its parent, BCFA.

17. Contingent liabilities:

The Company, in conducting its usual business activities, is involved in various legal proceedings and litigation, the outcome of which is indeterminable. It is the Company's policy to carry adequate insurance to minimize the financial risk associated with such matters. Management is of the opinion that the aggregate net liability, if any, of these proceedings and litigation would not be significant to the Company. Any additional future costs or recoveries, which differ from the accrued amounts, will be recorded as expenses or revenues as determined.

Corporate Directory

Board of Directors (April 1, 2006 – March 31, 2007)

Elizabeth J. Harrison, QC
Chair

Thomas W. Harris [1]
Vice Chair

Douglas E. Allen [1, 2]

Peter R.B. Armstrong [3] (resigned March 31, 2007)

Sandy M. Fulton [3]

David L. Hahn

John R. Henderson, FCA [1, 2]

Doreen J. Hewitt [2]

Maureen V. Macarenko [1, 3]

Robert W. McCaskill [2, 3]

A. Daniel Miller (effective May 15, 2007)

G. Raymond Whitehead [3]

Graham M. Wilson [1, 2]

1. Audit & Finance Committee
2. Governance & Human Resources Committee
3. Safety, Health, Environment & Security Committee

Senior Officers of the Company

David L. Hahn
President & Chief Executive Officer

Robert P. Clarke
Executive Vice President & Chief Financial Officer

Michael J. Corrigan
Executive Vice President & Chief Operating Officer

William R. Cottick
Executive Vice President, Corporate Affairs & General Counsel

Glen N. Schwartz
Executive Vice President, Human Resources & Corporate Development

Captain Trafford M. Taylor
Executive Vice President, New Vessel Construction & Industry Affairs

Officers of the Company

Manuel A. Achadinha
Vice President, Terminal Operations

Captain George A. Capacci
Vice President, Fleet Operations

Mark F. Collins
Vice President, Engineering

Geoffrey H. Dickson
Vice President, Food & Retail Operations

L. Blaine Ellis
Vice President, Employee Relations

M. Alana Gallagher
Treasurer

Cynthia M. Lukaitis
Vice President & Corporate Secretary

D.W. James Marshall
Vice President, Safety, Security & Environment

Daniel Wong
Vice President, Corporate Relations

B.C. Ferry Authority 2006/07 Annual Report

A Message from the Chair	81
2006/07 Annual Report	82
Summary of Meetings	83
Statement of Financial Position	86
Corporate Directory	Inside Back Cover

A Message From The Chair

The B.C. Ferry Authority is an independent, no-share corporation that holds the single issued voting share of British Columbia Ferry Services Inc. The Authority appoints the Board of Directors of British Columbia Ferry Services Inc. Currently, the members of the B.C. Ferry Authority Board are also directors of British Columbia Ferry Services Inc.

The B.C. Ferry Authority is governed by the *Coastal Ferry Act*, which establishes a process for the appointment of directors to ensure broad regional representation. In accordance with the Act, the Authority has a nine-member Board of Directors comprised of individuals with a wide range of experience.

Four directors are appointed from nominations received from four appointment areas, comprised of 13 coastal regional districts. In addition, one director is appointed from nominations from the union representing the employees of British Columbia Ferry Services Inc., two directors are appointed from the community-at-large and two additional directors are appointed by the provincial government.

The Board adheres to the highest corporate governance standards in its deliberations.

Elizabeth J. Harrison, QC
Chair

B.C. Ferry Authority 2006/07 Annual Report

The B.C. Ferry Authority (the "Authority") is a corporation without share capital that owns the single issued voting share of the operating company, British Columbia Ferry Services Inc. ("BCFS"). The Province of British Columbia is the holder of all of the preferred shares of BCFS. The Authority appoints the Board of Directors of BCFS.

The Authority is established and governed by the *Coastal Ferry Act* (the "Act"). In accordance with the Act, the Authority has adopted high standards of public and stakeholder accountability that require the Authority's financial and operating performance, as well as its process for appointing qualified individuals to serve as directors, to be open to public view.

Appointment of Directors

The Authority has a nine-member Board of Directors, the required composition of which is set out in the Act and includes regional and stakeholder representation. Four directors are appointed by the Board from nominees of four Appointment Areas, comprised of coastal regional districts, and one director is appointed from the nominees of the BC Ferry & Marine Workers' Union, the trade union representing the employees of BCFS. The Board also includes two directors appointed by the Province of British Columbia and two additional directors appointed by the Board from members of the community-at-large.

The *Coastal Ferry Act* requires that the terms of three Directors of the Authority expire each year. The first appointments to the Board were staggered such that three appointments were made for each of one, two and three years. Directors may serve for up to two consecutive terms (or three consecutive terms in the case of current Directors who served on the first Board of the Authority). At present, as a matter of Board policy, the directors of the Authority are also directors of the operating company, BCFS.

The appointment terms of three directors expired March 31, 2007. During the year, the Board sought and received nominations for appointment to the Board from the BC Ferry & Marine Workers' Union and also considered qualified candidates for appointment from the community-at-large. The nominations from the BC Ferry & Marine Workers' Union included the incumbent director who, together with the incumbent director from the community-at-large, was selected and re-appointed to the Board. The Province of British Columbia also reappointed its incumbent director. All three appointments took effect April 1, 2007 for terms of three years.

During the year, two primary objectives continued to guide the deliberations of the Board in selecting the individuals to serve as directors of the Authority. Firstly, it was to ensure that the composition of the Board meets the requirements of the Act and, secondly, it was to ensure that collectively, the Board includes individuals with the skills and experience necessary to ensure the sound performance of the Authority and the effective interaction and operation of the Board. The specific criteria that guided the Board in its appointment process during the year are reflected in the Skills and Experience Profile adopted by the Authority.

By-Laws of the Authority

As part of the Director appointment process undertaken in the previous year, the Board identified certain amendments to the Skills and Experience Profile in the areas of "Statutory Qualifications", "Personal Attributes" and "Key Skills" that it considered would enhance the effective operation of the Board. The Skills and Experience Profile is included as Schedule A to the General Bylaws of the Authority and, in accordance with the Act, the amendments were posted for public view on the Authority's website prior to their taking effect on September 1, 2006. There were no other amendments made to the General Bylaws of the Authority during the year.

Meetings

The Board meets regularly to conduct its business. During the year, the Board and its Committees met on 17 occasions. This included the Annual General Meeting of the Authority held in accordance with section 18 of the Act. A summary of the meetings of the Board and its Committees follows.

B.C. Ferry Authority Summary of Meetings 2006/07

Date	Type	Outcomes
June 6, 2006	Audit & Finance Committee	· Financial statements of the Authority for the year ended March 31, 2006 recommended for approval to the Board · Independence letter and findings report on the audit process received from the External Auditor · Results and comments for the Committee, as contained in the Board Self Assessment Evaluation Report, reviewed
June 7, 2006	Governance Committee	· Report from the Chair of the Governance Committee on the review of conflict of interest forms completed by Directors and Officers of the Authority · Report from the Chair of the Governance Committee on written declarations for the Directors of BCFA attesting to their independence · Process for appointment of Directors effective April 1, 2007 discussed
June 8, 2006	Board of Directors	· Financial statements of the Authority for the year ended March 31, 2006 approved · General Counsel authorized to execute, on behalf of the Authority, the shareholder's unanimous consent resolutions pertaining to all of the business required to be transacted at the Annual General Meeting of British Columbia Ferry Services Inc. · Process for appointment of Directors effective April 1, 2007 discussed · 2006 Annual General Meeting of the Authority discussed; date, time and location confirmed
August 16, 2006	Audit & Finance Committee	· Financial statements of the Authority for the three months ended June 30, 2006 recommended for approval to the Board
August 17, 2006	Board of Directors	· Financial statements of the Authority for the three months ended June 30, 2006 approved · 2005/06 Annual Report of the Authority approved
September 20, 2006	Audit & Finance Committee	· Discussion with the External Auditor
September 20, 2006	Governance Committee	· Process for appointment of Directors effective April 1, 2007 discussed · Communications protocol reviewed and confirmed · Timeline for next external review of Director compensation confirmed · Progress made in responding to the recommendations from the 2005/06 Board of Directors self assessment evaluation discussed · Process for the 2006/07 Board of Directors Self Assessment Evaluation discussed
September 21, 2006	Board of Directors	· Process for appointment of Directors effective April 1, 2007 discussed · Process for the 2006/07 Board of Directors self assessment evaluation confirmed
September 21, 2006	Annual General Meeting	· Annual General Meeting held pursuant to the *Coastal Ferry Act* (section 18)
November 27, 2006	Audit & Finance Committee	· Financial statements of the Authority for the six months ended September 30, 2006 recommended for approval to the Board · 2006/07 terms of engagement for the External Auditor approved · Committee meeting dates for 2007/08, 2008/09 and 2009/10 approved

B.C. Ferry Authority Summary of Meetings 2006/07

Date	Type	Outcomes
November 28, 2006	Governance Committee	· Process for appointment of Directors effective April 1, 2007 discussed · Committee meeting dates for 2007/08, 2008/09 and 2009/10 approved
November 29, 2006	Board of Directors	· Financial statements of the Authority for the six months ended September 30, 2006 approved · Board meeting dates for 2007/08, 2008/09 and 2009/10 approved
February 20, 2007	Audit & Finance Committee	· 2007/08 operating budget for the Authority recommended for approval to the Board · Financial statements of the Authority for the nine months ended December 31, 2006 recommended for approval to the Board
February 21, 2007	Governance Committee	· Process for appointment of Directors effective April 1, 2007 discussed · Skills and experience of the Board reviewed · Committee composition discussed
February 27, 2007	Board of Directors	· 2007/08 operating budget for the Authority approved · Financial statements of the Authority for the nine months ended December 31, 2006 approved · Process for appointment of Directors effective April 1, 2007 discussed
March 28, 2007	Governance Committee	· Results of Board of Directors' 2006/07 self assessment evaluation reviewed and discussed · Appointment of Director from the community-at-large for a three-year term commencing April 1, 2007 recommended for approval to the Board · Appointment of Director nominated by the trade union representing the employees of British Columbia Ferry Services Inc. for a three-year term commencing April 1, 2007 recommended for approval to the Board · Ratification of provincial appointment to the Board of Directors for a three-year term commencing April 1, 2007 recommended to the Board subject to confirmation of such appointment from the Province · Appointments of Chair and Vice Chair effective April 1, 2007 recommended for approval to the Board · Establishment of a Nominating Committee recommended for approval to the Board · Committee Chairs and membership effective April 1, 2007 recommended for approval to the Board
March 29, 2007	Board of Directors	· Results of Board of Directors' 2006/07 self assessment evaluation reviewed discussed · Director from the community-at-large appointed for a three-year term commencing April 1, 2007 · Director nominated by the trade union representing the employees of British Columbia Ferry Services Inc. appointed for a three-year term commencing April 1, 2007 · Provincial appointment to the Board of Directors for a three-year term commencing April 1, 2007 ratified subject to confirmation of such appointment from the Province · Nominating Committee established effective April 1, 2007 · Chair and Vice Chair effective April 1, 2007 appointed · Committee Chairs and members effective April 1, 2007 appointed · Decrease in the number of Directors of British Columbia Ferry Services Inc. from twelve to eleven effective April 1, 2007, approved · Directors of British Columbia Ferry Services Inc. effective April 1, 2007 appointed

Auditors' Report

To the Board of Directors, B.C. Ferry Authority

We have audited the statement of financial position of B.C. Ferry Authority as at March 31, 2007 and the statements of operations and changes in net assets for the year then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Authority as at March 31, 2007 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Victoria, Canada
May 17, 2007

Statement of Financial Position (expressed in thousands)

Assets As at March 31		2006
Investment in British Columbia Ferry Services Inc.	$ 203,570	$ 99,551
	$ 203,570	$ 99,551
Net Assets		
Invested in common share of British Columbia Ferry Services Inc.	$ 1	$ 1
Accumulated undistributed earnings of British Columbia Ferry Services Inc.	203,569	99,550
	$ 203,570	$ 99,551

See accompanying notes to financial statements.

On behalf of the Board:

Director, Graham M. Wilson

Director, Elizabeth J. Harrison, QC

Statement of Operations (expressed in thousands)

Years ended March 31		2006
Revenue:		
Distributable earnings of British Columbia Ferry Services Inc. (note 2)	$ 104,019	$ 43,827
Expenses:		
Administration	14	100
Recovery from British Columbia Ferry Services Inc. (note 3)	(14)	(100)
	-	-
Excess of revenue over expenses	$ 104,019	$ 43,827

Statement of Changes in Net Assets (expressed in thousands)	**Invested in BCFSI**	**Undistributed Earnings of BCFSI**	**Total**
Balance, March 31, 2006	$ 1	$ 99,550	$ 99,551
Excess of revenue over expenses	-	104,019	104,019
Balance, March 31, 2007	$ 1	$ 203,569	$ 203,570

See accompanying notes to financial statements.

Notes to Financial Statements
(expressed in thousands)

B.C. Ferry Authority (the "Authority") was established by the *Coastal Ferry Act* (British Columbia) (the "Act") on April 1, 2003 as a corporation without share capital. The Authority is governed by a board of nine directors. The board of directors appoints replacements for outgoing directors for seven of the positions as follows:

- four appointed from nominees provided to the board by each of the four appointment areas consisting of those coastal regional districts that the Lieutenant Governor in Council for British Columbia may prescribe, with one director appointed from each area;
- one appointed from nominees provided by the trade union representing the employees of the British Columbia Ferry Services Inc. ("BCFSI");
- two appointed from qualified individuals as defined in the Act.

The Lieutenant Governor in Council for British Columbia appoints the other two director positions from qualified individuals as terms expire. The terms of three director positions expire each fiscal year.

The Authority's primary purpose is to hold the shares of BCFSI, a company incorporated under the Business Corporations Act (British Columbia), which provides coastal ferry services in British Columbia. The Province of British Columbia (the "Province") contributed the initial capital to the Authority to fund the purchase of the BCFSI common share. The Act provides that upon a sale of the common share of BCFSI held by the Authority, the Province is to be repaid its initial contribution and the Authority is dissolved. The Act also provides that upon dissolution of the Authority, all remaining assets of the Authority, if any, vest in the Province.

1. Significant accounting policies:

(a) Basis of presentation:

The financial statements are prepared in accordance with Canadian generally accepted accounting principles for not-for-profit entities. The Authority's investment in its wholly owned subsidiary, BCFSI is accounted for by the equity method. Under the equity method the original cost of the investment is adjusted for the Authority's share of post-acquisition earnings or losses less dividends.

(b) Revenue recognition:

The Authority follows the deferral method of accounting for contributions. The Authority does not expect to receive endowment contributions.

(c) Taxes:

The Authority and BCFSI are exempt from federal and provincial income taxes.

(d) Statement of Cash Flows:

A statement of cash flows has not been included with these statements as it does not provide additional information.

(e) Comparative figures:

Certain comparative figures have been reclassified to conform to the presentation adopted for the current period.

2. Distributable earnings of British Columbia Ferry Services Inc.:

The distributable earnings of BCFSI consist of the current period net earnings, less any dividends paid in the current period and less a reserve for undeclared preferred share dividend, if any.

Years ended March 31	2007	2006
Net earnings of BCFSI	$ 110,057	$ 49,865
Dividends paid on 8% cumulative preferred shares	(6,038)	(6,038)
	$ 104,019	$ 43,827

3. Recovery from British Columbia Ferry Services Inc.:

The Act provides that BCFSI is responsible for paying any expenses that are incurred by the Authority.

Statement of Financial Position

4. Subsidiary supplemental information:

The consolidated financial position and operating results for BCFSI and its wholly-owned subsidiaries are summarized below:

As at March 31		2006
Current assets	$ 237,590	$ 63,093
Capital and other assets	978,185	770,584
	$ 1,215,775	$ 833,677
Current liabilities	$ 170,402	$ 142,170
Accrued employee future benefits	13,755	16,737
Unrealized losses on derivative instruments	2,831	-
Long-term debt and capital lease obligations	749,740	499,742
	936,728	658,649
Shareholders' equity		
Common share held by the Authority	1	1
Preferred shares (a)	75,477	75,477
Retained earnings	203,569	99,550
	279,047	175,028
	$ 1,215,775	$ 833,677

Years ended March 31		2006
Revenue (including gains)	$ 657,895	$ 579,411
Expenses (including losses)	547,838	529,546
Net earnings	110,057	49,865
Cash flows from operating	160,460	98,752
Cash flows from financing	266,775	(6,730)
Cash flows from investing	(249,403)	(131,255)

(a) The outstanding non-voting, 8% cumulative preferred shares are held by the Province and are convertible to common shares upon a sale of the outstanding common share. Special rights attached to the preferred shares restrict BCFSI's ability to issue share capital and to declare dividends.

Corporate Directory

B.C. Ferry Authority
Board of Directors (April 1, 2006 – March 31, 2007)

Elizabeth J. Harrison, QC
Chair
(Community-at-large appointment)

Thomas W. Harris [1]
Vice Chair
(Central Vancouver Island & Northern Georgia Strait appointment area)

Douglas E. Allen [1,2]
(Community-at-large appointment)

Sandy M. Fulton
(Province of B.C. appointment)

John R. Henderson, FCA [1,2]
(Southern Mainland appointment area)

Doreen J. Hewitt [2]
(Southern Vancouver Island appointment area)

Maureen V. Macarenko [1]
(Northern Coastal & North Island appointment area)

G. Raymond Whitehead
(Organized labour appointment)

Graham W. Wilson [1,2]
(Province of B.C. appointment)

1. Audit & Finance Committee
2. Governance Committee

Officers

Elizabeth J. Harrison, QC
Chair

Thomas W. Harris
Vice Chair

William R. Cottick
Executive Vice President, Corporate Affairs & General Counsel

Cynthia M. Lukaitis
Vice President & Corporate Secretary

BCFerries

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